

ORIGINAL
2 bcl
UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF PENNSYLVANIA
(Harrisburg Division)

UNITED STATES FIDELITY AND
GUARANTY COMPANY,
Plaintiff

v.

BRUCE J. BROWN and BROWN
SCHULTZ SHERIDAN & FRITZ,
Defendants.

CIVIL ACTION NO. 1:01-CV-00813

JUDGE CONNOR

MJ Smyser ✓

FILED
HARRISBURG, PA.

OCT 10 2002

AFFIDAVIT OF BRUCE D. LEVIN

Bruce Levin, on oath, deposes and states as follows:

MARY E. D'ANDREA, CLERK
PCF MS
Deputy Clerk

1. I am a partner in the firm of Bernkopf, Goodman & Baseman LLP, which maintains a business address at 125 Summer Street, Boston, Massachusetts and am a member in good standing of the Massachusetts bar. I am one of the attorneys representing United States Fidelity and Guaranty Company ("USF&G") in the above-captioned matter. I am making this affidavit solely for the purpose of authenticating certain documents in support of United States Fidelity & Guaranty Company's Opposition to the Defendants' Motion for Summary Judgment.

2. A true copy of the Complaint (exhibits omitted) filed by USF&G is attached hereto and incorporated herein as Exhibit "1."

3. A true copy of USF&G's Answers to Defendants' Set of Interrogatories is attached hereto and incorporated herein as Exhibit "2."

4. A true copy of Expert Report of Steve J. DeBruyn is attached hereto and incorporated herein as Exhibit "3."

5. A true copy of the Supplemental and Rebuttal Expert Report of Steve J. DeBruyn is attached hereto and incorporated herein as Exhibit 4.”

6. True copies from excerpts of the Deposition of Bruce Brown dated January 17, 2002 are attached hereto and incorporated herein as Exhibit “5.”

7. True copies from excerpts of the Deposition of Susanne Ehgartner dated June 11, 2002 are attached hereto and incorporated herein as Exhibit “6.”

8. True copies from excerpts of the Deposition of Deborah Bowman dated May 21, 2002 are attached hereto and incorporated herein as Exhibit “7.”

9. True copies from excerpts of the Deposition of Stephen Salazar dated May 22, 2002 are attached hereto and incorporated herein as Exhibit 8.”

10. True copies from excerpts of the Deposition of James Daily dated April 18, 2002 and June 27, 2002 are attached hereto and incorporated herein as Exhibit “9.”

11. True copies from excerpts of the Deposition of Anthony Phillips dated April 17, 2002 are attached hereto and incorporated herein as Exhibit “10.”

12. True copies from excerpts of the Deposition of David Hussey dated May 28, 2002 are attached hereto and incorporated herein as Exhibit “11.”

13. A true copy of Document BY00500 is attached hereto and incorporated herein as Exhibit “12.”

14. A true copy of Document USFG/BS 01853 is attached hereto and incorporated herein as Exhibit “13.”

15. A true copy of Document BS 01590 is attached hereto and incorporated herein as Exhibit “14.”

16. A true copy of Document BS 00772 is attached hereto and incorporated herein as Exhibit "15."

17. A true copy of Document BS 01755 is attached hereto and incorporated herein as Exhibit "16."

18. A true copy of Document BS 00169 is attached hereto and incorporated herein as Exhibit "17."

19. A true copy of Document USFG/BS 0908 is attached hereto and incorporated herein as Exhibit "18."

20. A true copy of Document USFG/BS 924 is attached hereto and incorporated herein as Exhibit "19."

21. A true copy of Document USFG/BS 1252 is attached hereto and incorporated herein as Exhibit "20."

22. A true copy of Document USFG/BS 0870 is attached hereto and incorporated herein as Exhibit "21."

23. A true copy of Document USFG/BS 0860-0869 is attached hereto and incorporated herein as Exhibit "22."

24. A true copy of SAS no. 1, AU section 230 is attached hereto and incorporated herein as Exhibit "23."

25. A true copy of SAS no. 22, AU section 311 is attached hereto and incorporated herein as Exhibit "24."

26. A true copy of SAS no. 31, AU section 326 is attached hereto and incorporated herein as Exhibit "25."

27. A true copy of Document BS 00774 is attached hereto and incorporated herein as Exhibit "26."

28. A true copy of Document BS 2045 is attached hereto and incorporated herein as Exhibit "27."

29. True copies from excerpts of the Deposition of John Ortenzio dated May 23, 2002 is attached hereto and incorporated herein as Exhibit "28."

30. True copies of excerpted pages from the audited financial statements for the years ended December 31, 1995 through 1998 are attached hereto and incorporated herein as Exhibit "29."

31. A true copy of the 1996 Audit Report is attached hereto and incorporated herein as Exhibit "30."

32. A true copy of the 1997 Audit Report is attached hereto and incorporated herein as Exhibit "31."

33. A true copy of the 1998 Audit Report is attached hereto and incorporated herein as Exhibit "32."

34. A true copy of Response No. 20 of Defendant Brown, Shultz, Sheridan & Fritz's Responses and Objections to United States Fidelity and Guaranty Company's First Request for Production of Documents is attached hereto and incorporated herein as Exhibit "33."

35. A true copy of Section 12.049 of the Horwath International Audit Manual is attached hereto and incorporated herein as Exhibit "34."

36. A true copy of the Guaranty Agreement dated December 1, 1998 from Pennsylvania Contractors Insurance Company to CCI Construction, Inc. is attached hereto and incorporated herein as Exhibit "35."

Signed under the pains and penalties of perjury this 9th day of October 2002.

A handwritten signature in cursive script, reading "Bruce D. Levin (PSM)", written over a horizontal line.

Bruce D. Levin

#254551 v1/36432/87

UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF PENNSYLVANIA
(Harrisburg Division)

UNITED STATES FIDELITY AND
GUARANTY COMPANY,
Plaintiff

v.

BRUCE J. BROWN and
BROWN SCHULTZ SHERIDAN &
FRITZ,
Defendants

CIVIL ACTION NO. 01-

FILED
HARRISBURG, PA

MAY 09 2001

MARY E. D'ANDREA, CLERK
Per
Deputy Clerk

COMPLAINT OF UNITED STATES FIDELITY AND GUARANTY COMPANY

I. INTRODUCTION

By this action, the United States Fidelity and Guaranty Company ("USF&G"), a performance and payment bond surety to CCI Construction Co. ("CCI"), seeks to recover damages which it has sustained as a result of its extension of surety credit and the issuance of construction surety bonds to CCI in reliance upon audited financial statements prepared by the defendants, Bruce J. Brown and Brown Schultz Sheridan & Fritz ("Brown Schultz"), that contain misrepresentations, omissions and/or inaccurate information.

II. PARTIES, JURISDICTION AND VENUE

A. Plaintiff

1. Plaintiff, USF&G is a corporation organized under the laws of Maryland and maintains a principal place of business in St. Paul, Minnesota.

B. Defendant

2. Defendant, Brown Schultz, is, upon information and belief, a professional corporation formed, upon information and belief, pursuant to the laws of the Commonwealth of Pennsylvania with a principal place of business at 1011 Mumma Road, Wormleysburg, Pennsylvania.

3. Defendant, Bruce J. Brown ("Brown") is, upon information and belief, an individual residing in the vicinity of Harrisburg, Pennsylvania, and is a partner with Brown Schultz, as well as the partner-in-charge of the CCI account.

C. Jurisdiction and Venue

4. Jurisdiction obtains pursuant to 28 U.S.C. §1332(a), as USF&G is a Maryland corporation with a principal place of business in St. Paul, Minnesota and Brown Schultz and Brown are citizens of the Commonwealth of Pennsylvania and have a principal place of business or residence in Pennsylvania. The amount in controversy, exclusive of interest and costs, exceeds \$75,000.00.

5. Venue obtains pursuant to 28 U.S.C. §1391(a) as Brown Schultz has a principal place of business in the Middle District of Pennsylvania and Brown is, upon information and belief, a resident in the Middle District of Pennsylvania.

III. FACTUAL BACKGROUND

USF&G Issues Bonds To CCI

6. CCI was a contractor engaged in construction work on public and private construction projects and maintained principal offices in Camp Hill, Pennsylvania.

7. USF&G is in the business of, *inter alia*, issuing payment and performance bonds on behalf of contractor and subcontractor principals engaged in the performance of work on public and private construction projects.

8. In general, in connection with the issuance of payment and performance bonds, USF&G establishes a "bonding program" for its contractor and subcontractor principals, thereby establishing a surety credit line for each such contractor and subcontractor principal.

9. In general, payment and performance bonds are issued by USF&G to such contractor and subcontractor principals pursuant to the bonding program established, as described in the previous paragraph.

10. As a condition of the establishment and/or extension of surety credit to CCI and the issuance of the payment and performance bonds to CCI, USF&G required that CCI furnish to it annually an audit report prepared by an independent certified public accountant consisting of, *inter alia*, an audit of CCI's balance sheet and income statement.

11. On information and belief, at all times material and relevant to this action, Brown and Brown Schultz have been engaged in the business of performing work as independent certified public accountants, including, *inter alia*, preparing audited financial statements for construction contractors and subcontractors for use by their bonding companies.

Relying Upon the Audits, USF&G Issues Bonds

12. Brown and Brown Schultz prepared audited financial statements for CCI for the years ended December 31, 1996, December 31, 1997 and December 31, 1998 (collectively, the "Audited Financial Statements"). Copies of the Audited Financial Statements are attached hereto as Exhibits "A," "B" and "C," respectively.

13. Brown and Brown Schultz knew that the Audited Financial Statements would be provided by CCI to its bonding company, which at all times material and relevant to this action was USF&G.

14. Brown and Brown Schultz knew that CCI's bonding company – USF&G – would rely upon the Audited Financial Statements to determine whether to extend, cancel or modify the surety credit program which USF&G established for CCI and to issue payment and performance bonds to CCI.

15. On or about May 1, 1997, USF&G received a copy of Brown Schultz's Independent Auditor's Report dated February 12, 1997 for CCI for the year ended December 31, 1996 and 1995 (the "1996 Audit Report").

16. In reliance upon the 1996 Audit Report, USF&G agreed to extend surety credit to CCI and, thereafter, USF&G issued payment and performance bonds to CCI for, *inter alia*, the following projects:

	<u>PROJECT</u>	<u>DESCRIPTION</u>	<u>BOND NO.</u>	<u>BOND DATE</u>	<u>PENAL SUM AMOUNT</u>
A.	Albemarle – Charlottesville Regional Jail	Additions and Renovations to Regional Jail	26-0120-12995-98-7	2/6/98	\$14,682,402.00
B.	Johnstown	Air Traffic Control Tower	26-0120-41362-97-1	8/15/97	\$ 3,734,530.00
C.	Lord Fairfax	Phase I-Lord Fairfax Community College	26-0120-41364-97-4	1/5/98	\$ 7,409,292.00
D.	Outlook-Hilliard	Construction of Outlook Point at Hilliard	26-0120-13008-98-0	2/23/98	\$ 5,598,750.00

17. On or about March 5, 1998, USF&G received a copy of Brown Schultz's Independent Auditor's Report dated February 10, 1998 for CCI for the years ended December 31, 1997 (the "1997 Audit Report").

18. In reliance upon the 1997 Audit Report, USF&G agreed to extend surety credit to CCI and, thereafter, USF&G issued payment and performance bonds to CCI for, *inter alia*, the following projects:

	<u>PROJECT</u>	<u>DESCRIPTION</u>	<u>BOND NO.</u>	<u>BOND DATE</u>	<u>PENAL SUM AMOUNT</u>
A.	Germsplasm Ctr	Phase I and II; National Plant Germsplasm	26-0120-28306-98-1	4/7/98	\$15,647,035.00
B.	James River	Construction of Juvenile Detention Center	26-0120-08946-99-2	1/7/99	\$ 7,220,942.00
C.	Outlook- Chesterfield	Construction of Outlook Point at Chesterfield	26-0120-29307-98-8	6/24/98	\$ 3,919,156.00
D.	Outlook- Westerville	Construction of Outlook Point at Westerville	26-0120-28312-98-1	9/27/98	\$ 5,591,730.00
E.	PA Tpkbldg-Kost Rd	Central Administration Building Renovation	26-0120-40371-99-1	4/30/98	\$28,231,945.00
F.	Perry Point	80 bed Psychiatric Care Building	26-0120-13002-98-1	3/12/98	\$13,297,844.00
G.	Scott A.F. Base	Aircraft Parking Apron & Jet Fuel Storage	26-0120-28305-98-5	3/30/98	\$18,880,298.00
H.	VCU Life Science	The Life Sciences Building	26-0120-08953-99-9	1/15/99	\$21,927,111.00

19. On or about March 1, 1999, USF&G received a copy of Brown Schultz's Independent Auditor's Report dated February 10, 1999 for CCI for the year ended December 31, 1998 (the "1998 Audit Report").

20. In reliance upon the 1998 Audit Report, USF&G agreed to extend surety credit to CCI and, thereafter, issued payment and performance bonds to CCI for, *inter alia*, the following projects:

	<u>PROJECT</u>	<u>DESCRIPTION</u>	<u>BOND NO.</u>	<u>BOND DATE</u>	<u>PENAL AMOUNT</u>
A.	Bedford County, State Route 0030	Road Improvements	26-0120-08963-99-4	6/17/99	\$ 514,976.00
B.	Cambria County SR 0022	Road Improvements	26-0120-08959-99-7	5/13/99	\$ 835,299.00
C.	Summerdale	Sitework-Laboratory Centers of Excellence	26-0120-08958-99-1	7/7/99	\$ 1,688,139.00
D.	Cool & Cold Aqua	Buried Process Water Lines and Valve	26-0120-40376-99-3	8/12/99	\$ 191,083.00
E.	Cool & Cold Aqua	Construction of National Center	26-0120-08961-99-1	4/15/99	\$12,191,000.00
F.	SR II Perry Cnty	Excavation, Presplit Blasting	26-0120-08953-99-9	3/2/99	\$ 4,126,478.00

(The projects and the bonds described in paragraphs 16, 18 and 20 of this Complaint are collectively referred to as the "Projects" and the "Bonds," respectively).

21. The Audited Financial Statements prepared by Brown Schultz were inaccurate, contained omissions and/or were misleading in whole or in part.

CCI Defaults And USF&G Incurs Heavy Losses

22. On or about September, 1999, CCI advised USF&G that it lacked the financial resources to continue its operations and, consequently, would not be able to complete its work and pay its suppliers and subcontractors relative to the Projects.

23. Subsequently, USF&G, as the surety for the payment and performance bonds which it issued for the Projects, was required to and did expend substantial sums satisfying the claims of CCI's unpaid vendors, employees and subcontractors, and in completing the Projects.

24. On or about May 19, 2000, CCI filed for bankruptcy.

25. As of this date, USF&G has incurred losses of approximately \$31,816,895 in connection with the Bonds issued in reliance upon the 1996, 1997 and 1998 Audited Financial Statements.

IV. USF&G'S CLAIMS AGAINST BROWN AND BROWN SCHULTZ

Count I – Negligent Misrepresentation

26. USF&G hereby restates and realleges the allegations contained in paragraphs 1 through 25 as if fully set forth herein.

27. At the times relevant and material to this action, Brown and Brown Schultz knew that the Audited Financial Statements would be furnished to USF&G.

28. At the times relevant and material to this action, Brown and Brown Schultz knew that as an inducement to extend surety bond credit to CCI, USF&G would rely on the Audited Financial Statements.

29. Brown and Brown Schultz owed a duty of care to USF&G as an intended recipient of the Audited Financial Statements.

30. USF&G justifiably and reasonably relied upon the Audited Financial Statements.

31. USF&G justifiably and reasonably relied upon the Audited Financial Statements to its detriment.

32. The Audited Financial Statements were inaccurate, misleading and/or contained omissions in whole or in part.

33. As a direct and proximate result of Brown and Brown Schultz's negligent misrepresentations contained in the Audited Financial Statements as aforesaid, USF&G has sustained and continues to sustain damages for which Brown and Brown Schultz are liable to USF&G, together with costs, interest and attorneys' fees.

WHEREFORE, USF&G demands that this Court:

1. Enter judgment against Brown and Brown Schultz in favor of USF&G as to Count I of this Complaint in the amount of its damages, plus interest, costs and reasonable attorneys' fees;
2. Grant USF&G such other and further relief as is proper and just.

UNITED STATES FIDELITY &
GUARANTY COMPANY,
By its attorneys,

Jeffrey Rettig, Esq.
Thomas, Thomas & Hafer
305 North Front Street
Harrisburg, PA 17101
Telephone: (717) 237-7100
Telecopier: (717) 237-7105

and



Peter B. McGlynn, Esquire (BBO No. 333660)
Bruce D. Levin, Esquire (BBO No. 548136)
Bernkopf, Goodman & Baseman LLP
125 Summer Street, Suite 1300
Boston, Massachusetts 02110
Telephone: (617) 790-3000
Facsimile: (617) 790-3300

Dated: May ____, 2001
#222654 v1/36432/87

2

UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF PENNSYLVANIA
(Harrisburg Division)

UNITED STATES FIDELITY AND
GUARANTY COMPANY,
Plaintiff

v.

BRUCE J. BROWN and BROWN
SCHULTZ SHERIDAN & FRITZ,
Defendants.

CIVIL ACTION NO. 1:01-CV-00813

JUDGE KANE

**UNITED STATES FIDELITY AND GUARANTY COMPANY'S
ANSWERS TO DEFENDANTS' SET OF INTERROGATORIES**

Plaintiff, United States Fidelity & Guaranty Company (the "USF&G") responds to
Defendants' First Set of Interrogatories as follows:

I. STATEMENT AND GENERAL OBJECTIONS

1. USF&G objects to Defendants' interrogatories and instructions to the extent that they exceed the scope of both Fed.R.Civ.P. 33 and the Local Rules of the United States District Courts for the District of Pennsylvania.

2. Defendants' requests are extremely broad in scope and include information subject to the attorney-client privilege or the work produce doctrine. Accordingly, USF&G will answer all interrogatories as indicated below only to the extent that they are not subject to the attorney-client privilege or work product doctrine.

3. USF&G reserves the right to supplement its responses in the event that additional documents or information become available.

4. All documents proffered pursuant to Fed.R.Civ.P. 33(c) will be produced as required by the Federal Rules of Civil Procedure or as the parties may otherwise agree.

5. To the extent that any definition, instruction or interrogatory may be construed as calling for the identification of documents reflecting, referring or relating to a particular subject or subjects, USF&G construes such interrogatory as calling for the identification of documents which refer to the designated subject on the face of the documents. If, however, the interrogatory is to be construed otherwise, it would be impossible for USF&G to identify documents on the grounds that the definition, instruction or interrogatory is vague, ambiguous, overbroad and unduly burdensome, and is not reasonably calculated to lead to the discovery of admissible evidence.

6. USF&G hereby incorporates by reference each and every one of the general objections in to all of the following interrogatory responses.

II. ANSWERS

INTERROGATORY NO. 1

Identify all persons who participated in the preparation of your responses to Defendants' First Set of Interrogatories to Plaintiff.

ANSWER NO. 1

Without waiver of the general objections, USF&G states that the responses were prepared by Anthony Phillips, with the assistance of counsel.

INTERROGATORY NO. 2

Identify all persons, including but not limited to your present or former employees, who participated in the underwriting of payment and performance bonds issued to CCI.

ANSWER NO. 2

Without waiver of the general objections, and further objecting that "participated" is vague and ambiguous, USF&G states that the following individuals either worked for USF&G regarding the decision to create a bonding program for CCI or provided USF&G with material information, other than audit information, used to make that decision:

Stephen H. Salazar
Senior Underwriting Manager
St. Paul Surety Co.
2605 Interstate Drive
Harrisburg, PA 17110-9364

Jim Dailey
H.O. Surety, National Accounts
St. Paul Surety Co.
2605 Interstate Drive
Harrisburg, PA 17110-9464

Anthony Phillips
Bond Underwriter
St. Paul Surety Co.
2605 Interstate Drive
Harrisburg, PA 17110-9464

John Ortenzio, President
CCI Construction Co., Inc.
2500 Old Gettysburg Road
Camp Hill, PA 17011-7307

Shane Miller
Chief Operating Officer
CCI Construction Co., Inc.
2500 Old Gettysburg Road
Camp Hill, PA 17011-7307

David Barber
Chief Financial Officer
CCI Construction Co., Inc.
2500 Old Gettysburg Road
Camp Hill, PA 17011-7307

James C. Byerly, President
Byerly Insurance
525 North 12th Street
P.O. Box 525
Lemoyne, PA 17043-0525

Dave Dominiani
Vice President/Contract Bond Division
Byerly Insurance
525 North 12th Street
P.O. Box 525
Lemoyne, PA 17043-0525

INTERROGATORY NO. 3

Identify all persons, including but not limited to your present or former employees, who participated in the establishment of a bonding program for CCI.

ANSWER NO. 3

Without waiver of the general objections, and further objecting that "participated" is vague and ambiguous, USF&G states that the following individuals either worked for USF&G regarding the decision to create a bonding program for CCI or provided USF&G with material information, other than audit information, used to make that decision:

Stephen H. Salazar
Senior Underwriting Manager
St. Paul Surety Co.
2605 Interstate Drive
Harrisburg, PA 17110-9364

Jim Dailey
H.O. Surety, National Accounts
St. Paul Surety Co.
2605 Interstate Drive
Harrisburg, PA 17110-9464

Anthony Phillips
Bond Underwriter
St. Paul Surety Co.
2605 Interstate Drive
Harrisburg, PA 17110-9464

John Ortenzio, President
CCI Construction Co., Inc.
2500 Old Gettysburg Road
Camp Hill, PA 17011-7307

Shane Miller
Chief Operating Officer
CCI Construction Co., Inc.
2500 Old Gettysburg Road
Camp Hill, PA 17011-7307

David Barber
Chief Financial Officer
CCI Construction Co., Inc.
2500 Old Gettysburg Road
Camp Hill, PA 17011-7307

James C. Byerly, President
Byerly Insurance
525 North 12th Street
P.O. Box 525
Lemoyne, PA 17043-0525

Dave Dominiani
Vice President/Contract Bond Division
Byerly Insurance
525 North 12th Street
P.O. Box 525
Lemoyne, PA 17043-0525

INTERROGATORY NO. 4

State the factual basis for your contention that Brown Schultz's Audit Report for the year ended December 31, 1996 was inaccurate, contained omissions and/or was misleading, including but not limited to:

- a. The nature of each inaccuracy and/or omission contained in the 1996 Audit Report; and
- b. The manner in which the 1996 Audit Report was misleading.

ANSWER NO. 4

USF&G objects to this interrogatory on the grounds that it is impossible at this early stage of this legally and factually complex litigation to state in full detail the basis for any contention for which some, if not much, of the factual support lies in the hands of persons other than USF&G. In essence, this and the following contention interrogatories call upon USF&G to recite each and every fact, including each communication and document that would support each and every assertion in the Complaint. As such, they are an improper use of interrogatories under the Federal Rules of Civil Procedure. USF&G also states that the interrogatory is duplicative of information to be provided in expert reports which, pursuant to the Case Management Order dated August 17, 2001, are due on July 1, 2002. However, USF&G is providing responses to this interrogatory based, for the most part, on information known or available to them at this time. These responses do not include or incorporate information that will be obtained in the course of discovery and USF&G reserves the right to amend its responses to reflect such information. Additionally, the instant response focuses on major inadequacies of the audited financial statements for CCI for the year ended December 31, 1996 (the "1996 Audit Report") and is not intended to be a complete recitation of all inaccuracies, omissions and representations contained therein.

USF&G further states that some of the inaccuracies and omissions are relevant only when viewed in the context of other audits of CCI performed by Brown Schultz. Accordingly, USF&G incorporates herein by reference the responses to interrogatories nos. 8 and 12 as if fully set forth herein.

Several aspects of the planning stage of the 1996 Audit Report indicate that Brown Schultz did not perform to professional standards regarding the 1996 Audit Report. During the

planning stage of the audit, significantly greater consideration should have been given to the use of more expansive procedures in regards to management's representations, especially in relation to anticipated gross profit and estimated costs to complete on work-in-progress as of December 31, 1996.

On Form B-2, Part IV, "Evaluating and Considering the Effects of Overall Inherent Risk Factors," the auditor is instructed to consider the effect, individually and in the aggregate, on the audit scope of all significant risk factors identified in Part I of Form B-2. Further, the auditor is instructed to describe the various risk factors and reasons for its significance, any mitigating circumstances, the cycle/assertion most likely affected, and the effect on scope. Brown Schultz identified the following two separate risk factors: (1) that management personnel were awarded bonuses based on company's performance, and that (2) significant creditors were intended financial statement users.

For each of these risk factors, Brown Schultz documented as a mitigating circumstance that "[m]anagement team has high integrity; no problems in the past and none are anticipated." Brown Schultz also commented that these risk factors were likely to effect the "revenue/existence" cycle in regards to the first factor and the "expenditure/completeness" cycle in regards to the second factor. Finally, Brown Schultz documented that these risk factors would have no effect on the audit scope. This was due to audit procedures already in place which, purportedly, "usually result[s] in examining revenue 90%-100." Brown Schultz also noted that "search for unrecorded liabilities is performed." However, the risk factors during the planning stage of the audit were of such significance that Brown Schultz should have been aware that management personnel had an incentive to inflate earnings and net income and, accordingly, should have subjected CCI's financials to markedly greater scrutiny.

In addition to the two risk factors detailed above, Brown Schultz should have also considered the following factors in its audit work:

- (1) Accounting issues such as the complexity and contentiousness of accounting issues affecting the account (i.e. the various difficulties associated with auditing a construction company);
- (2) Auditing difficulties including the frequency or significance of difficult-to-audit transactions affecting the account (i.e. difficulties associated with auditing estimated costs-to-complete;
- (3) The complexity of calculations affecting the account; and
- (4) The extent of judgment involved in determining the account balance.

Despite the foregoing, on the Confirmation Control Sheet, it appears that only Accounts Receivable confirmations and legal representation letters were sent. The following do not appear to have been used or even considered:

- Confirmation of the various cash accounts;
- Confirmation of the Company's line of credit;
- Confirmation of significant subcontractor agreements; and
- Confirmation of the Company's investments.

In relation to indirect costs, the presentation of the financial statements appear not to be in accordance with GAAP. For example, it appears that costs of contracts for each individual contract as represented on the "Earnings from Contracts," "Completed Contracts" and "Contracts-in-Progress" schedules included only direct costs; indirect costs and general and administrative expenses are charged to expense as incurred. (See Note 1 to the financial statements). However, GAAP requires all indirect costs to be allocated to individual contracts

using a reasonable method. Therefore, GAAP does not allow a line item "Indirect Costs" to appear on the financial statements. The result of this departure from GAAP is that actual/estimated gross profit of each individual contract represented on the "Completed Contracts" and "Contracts-in-Progress" was overstated by the amount of indirect costs that should have been allocated to that job.

A comparison of the summary portion of the income statement between the years ended December 31, 1997 and December 31, 1996 also indicates serious inaccuracies. Brown Schultz analytically identified a potential error in the financial statements by performing an analytical review of the overall income statement. It identified an increase in the gross profit from 2.02% in 1995 to 5.39% in 1996. Although this represented an increase of only 3.37%, the 1996 percentage was 166% greater than the 1995 amount. Brown Schultz noted on the workpaper that the increase was the result of higher gross profit recognized from "capital" jobs in 1996.

In Brown Schultz' audit program concerning completed contracts, the procedure used, as described by Brown Schultz, was as follows: "[s]elected two jobs included in the completed contract listing . . . which were around 80% complete in the prior year, in order to get a good test of the client's estimating procedures." This testing was inadequate.

In the audit program dealing with completed contracts, only two contracts were "tested." These contracts represented less than 25% of the total amount of contracts completed during 1996. Therefore, the two contracts were not a representative sample.

In relation to the testing of CCI's job cost system, it appears that 25 job cost items were "haphazardly" selected and tested. This testing included, among other things, payroll costs. To test these costs, weekly transaction distribution reports were obtained. "Haphazardly," one line item for every month plus one additional line item for the fifth and seventh months were selected.

To verify that the transaction distribution represented the total weekly payroll, Brown Schultz agreed the gross payroll report total to the transaction distribution reports to the weekly payroll register total. As for other costs, Brown Schultz merely obtained the monthly purchase journals. Brown Schultz then haphazardly selected one line item that included a job cost and phase number from each month.

Brown Schultz noted that "[a]ll 25 cost items were traced to client source documentation to verify that the cost was coded to the correct job. Also, all cost items were agreed to the job cost history reports to verify proper posting." Brown Schultz also noted that "All invoice and payroll account coding relating to contracts is completed and approved by someone outside of the accounting department . . . [d]ue to this control, only 25 items needed to be selected for testing."

Brown Schultz did not document why a sample of only 25 items was considered a reasonable, representative sample.

It does not appear that job site visits were performed or even considered when the audit was planned. Since this procedure was not performed (nor were confirmation letters sent to subcontractors), there was virtually no independent confirmation or other verification of management's representations concerning the percentage of completion and the estimated costs to complete as of the balance sheet date. Nor was Brown Schultz able to obtain any independent verification of problems on the jobs that might not have been disclosed by management (with the exception of the confirmations received from the owners).

Several errors appear to have been made as to the "Disclosure Requirements" checklist. Question 2 under the section "Notes and Accounts Receivable" concerns amounts due from affiliates or subsidiaries. The preparer noted that this item was "insignificant." However, on the December 31, 1996 balance sheet, it was represented that \$268,583 was due from a shareholder.

At the same time, it had previously been documented that the Acceptable Projected Misstatement was \$100,000.00. Accordingly, the description of "insignificant" is inaccurate. Moreover, the allowance of doubtful accounts does not appear to have been disclosed, as is required under GAAP.

Summarily, in relation to the testing of contract billing and cost-related accounts, it appears that Brown Schultz performed little, if any, of the above-detailed procedures. It also appears that limited inquiries were made solely to Sherri Phillips, CCI's chief accounting person. There appears to be little, if any, documentation concerning inquiries and discussions made with the construction manager, the project manager of each individual significant job and other key, field employees. In addition, there appears to have been little, if any, analytical review performed on the jobs-in-progress, material departures from GAAP demonstrated by management (in regard to indirect costs), and little, if any, testing performed on the individual components of job costs (direct and indirect costs).

INTERROGATORY NO. 5

Identify all documents which support your contention that Brown Schultz's Audit Report for the year ended December 31, 1996 was inaccurate, contained omissions and/or was misleading.

ANSWER NO. 5

USF&G objects to this interrogatory on the grounds that it is impossible at this early stage of this legally and factually complex litigation to state in full detail the basis for any contention for which some, if not much, of the factual support lies in the hands of persons other than USF&G. In essence, this and the following contention interrogatories call upon USF&G to recite each and every fact, including each communication and document that would support each and every assertion in the Complaint. As such, they are an improper use of interrogatories under the

Federal Rules of Civil Procedure. USF&G also states that the interrogatory is duplicative of information to be provided in expert reports which, pursuant to the Case Management Order dated August 17, 2001, are due on July 1, 2002. However, USF&G is providing responses to this interrogatory based, for the most part, on information known or available to them at this time. These responses do not include or incorporate information that will be obtained in the course of discovery.

Without waiver of the general and foregoing objections, USF&G will make such documents available for inspection and copying at a reasonable time and place pursuant to Fed. R. Civ. P. 33(d). Such documents consist, in the main, of Brown Schultz' working papers, the audit and tax file, correspondence and the appropriate audit report, all of which were previously produced by Brown Schultz.

INTERROGATORY NO. 6

For each inaccuracy and/or omission identified in response to interrogatory no. 4, is it your contention that it was material to the issuance of the payment and performance bonds identified in Paragraph 16 of the Complaint? If so, state the factual basis for your contention and the sources of proof for the facts which support your contention.

ANSWER NO. 6

USF&G objects to this interrogatory on the grounds that it is impossible at this early stage of this legally and factually complex litigation to state in full detail the basis for any contention for which some, if not much, of the factual support lies in the hands of persons other than USF&G. In essence, this and the following contention interrogatories call upon USF&G to recite each and every fact, including each communication and document that would support each and every assertion in the Complaint. As such, they are an improper use of interrogatories under the Federal Rules of Civil Procedure. USF&G also states that the interrogatory is duplicative of

information to be provided in expert reports which, pursuant to the Case Management Order dated August 17, 2001, are due on July 1, 2002. However, USF&G is providing responses to this interrogatory based, for the most part, on information known or available to them at this time. These responses do not include or incorporate information that will be obtained in the course of discovery and USF&G reserves the right to amend its responses to reflect such information.

USF&G relied upon the unqualified opinion contained in the audit report in its decision as to the nature and extent of the bonding program it gave to CCI. The errors or omissions discussed in the response to interrogatory 4 resulted in the audit report inaccurately reflecting CCI's true financial condition and numerous risks inherent in the maintenance of a bonding program. Since USF&G would not have issued the bonding program to CCI which it did if the inaccuracies contained in the 1996 Audit Report were known by USF&G, all inaccuracies referred to in the response to interrogatory no. 4 are material because of the cumulative effect they had on the accuracy of the audit.

INTERROGATORY NO. 7

Is it your contention that defendants should have known of each of the inaccuracies and/or omissions identified in response to interrogatory no. 4 above? If so, state the factual basis for your contention and the sources of proof for the facts which support your contention.

ANSWER NO. 7

USF&G objects to this interrogatory on the grounds that it is impossible at this early stage of this legally and factually complex litigation to state in full detail the basis for any contention for which some, if not much, of the factual support lies in the hands of persons other than USF&G. In essence, this and the following contention interrogatories call upon USF&G to recite each and every fact, including each communication and document that would support each and every assertion in the Complaint. As such, they are an improper use of interrogatories under the

Federal Rules of Civil Procedure. However, USF&G is providing responses to this interrogatory based, for the most part, on information known or available to them at this time. These responses do not include or incorporate information that will be obtained in the course of discovery and USF&G reserves the right to amend its responses to reflect such information.

In that, *inter alia*, the errors and omissions identified in response to interrogatory 4 were apparent to USF&G upon review of the working papers and could likely have been either eliminated or avoided by the implementation of procedural and substantive steps mandated by GAAS and GAAP, as well as reasonable professional standards of practice, Brown Schultz either knew or should reasonably have known of such inaccuracies and omissions.

INTERROGATORY NO. 8

State the factual basis for your contention that Brown Schultz's Audit Report for the year ended December 31, 1997 was inaccurate, contained omissions and/or was misleading including but not limited to:

- a. The nature of each inaccuracy and/or omission contained in the 1997 Audit Report; and
- b. The manner in which the 1997 Audit Report was misleading.

ANSWER NO. 8

USF&G objects to this interrogatory on the grounds that it is impossible at this early stage of this legally and factually complex litigation to state in full detail the basis for any contention for which some, if not much, of the factual support lies in the hands of persons other than USF&G. In essence, this and the following contention interrogatories call upon USF&G to recite each and every fact, including each communication and document that would support each and every assertion in the Complaint. As such, they are an improper use of interrogatories under the Federal Rules of Civil Procedure. USF&G also states that the interrogatory is duplicative of

information to be provided in expert reports which, pursuant to the Case Management Order dated August 17, 2001, are due on July 1, 2002. However, USF&G is providing responses to this interrogatory based, for the most part, on information known or available to them at this time. These responses do not include or incorporate information that will be obtained in the course of discovery and USF&G reserves the right to amend its responses to reflect such information. Additionally, the instant response focuses on major inadequacies of the audited financial statements for CCI for the year ended December 31, 1997 (the "1997 Audit Report") and is not intended to be a complete recitation of all inaccuracies, omissions and representations contained therein.

USF&G further states that some of the inaccuracies and omissions are relevant only when viewed in the context of other audits of CCI performed by Brown Schultz. Accordingly, USF&G incorporates herein by reference the responses to interrogatories nos. 4 and 12 as if fully set forth herein.

As a part of the statements that were issued for the year ended December 31, 1997, the statement, as originally reported, contained current assets of \$15.3 million, other assets of \$1.4 million, total current liabilities of \$11.3 million and equity of \$5.4 million. As restated, the current assets were \$14.1 million, other assets were \$1.4 million, current liabilities were \$13.2 million and equity was \$2.3 million. The net effect of this is that retained earnings as originally reported were overstated by \$3.1 million dollars.

There was profit fade of \$2.8 million on the work in process as of December 31, 1997. By overstating the estimated profit on these jobs, Brown Schultz had materially overstated overbillings and net income for 1997. Brown Schultz did not properly allocate indirect costs and did not properly perform an audit of construction contracts in accordance with GAAS.

Moreover, significant profit increases and slippage were recognized from the represented work-in-progress as of December 31, 1997.

On Form B-2, Part IV, "Evaluating and Considering the Effects of Overall Inherent Risk Factors," the auditor is instructed to consider the effect, individually and in the aggregate, on audit scope of all significant risk factors identified in Part I of Form B-2. The auditor is further instructed to describe the various risk factors and reason for its significance, any mitigating circumstances, the cycle/assertion most likely affected, and the effect on scope. Brown Schultz identified the following four separate risk factors: (1) significant creditors who are financial statement users; (2) significant related party transactions; (3) competitive industry; and (4) management bonuses based on financial results.

For each of these risk factors, Brown Schultz documented as a mitigating circumstance that "[m]anagement team has high integrity; no problems in the past and none are anticipated." Brown Schultz also commented that these risk factors were not likely to effect any specific cycles. Finally, Brown Schultz documented that these risk factors would have no effect on the audit scope. This was due to audit procedures already in place, which, purportedly, "usually result[s] in examining revenue 90%-100%." Brown Schultz also noted that "search of unrecorded liabilities is performed." However, the risk factors during the planning stage of the audit were of such significance that Brown Schultz should have been aware that management (in particular, Shane Miller, CCI's Executive Vice-President, and the individual ultimately responsible for the compilation of the work-in-progress schedule, and Sherri Phillips, the individual responsible for the preparation of the financial statements) had an incentive to inflate earnings and net income and, accordingly, should have subjected CCI's financials to markedly greater scrutiny.

In addition to the four risk factors detailed above, Brown Schultz should have also considered the following factors in its audit work:

- (1) Accounting issues such as the complexity and contentiousness of accounting issues affecting the account (i.e. the various difficulties associated with auditing a construction company);
- (2) Auditing difficulties including the frequency or significance of difficult-to-audit transactions affecting the account (i.e. difficulties associated with auditing estimated costs-to-complete);
- (3) The complexity of calculations affecting the account; and
- (4) The extent of judgment involved in determining the account balance.

Therefore, during this planning stage, consideration should have been made of expanding procedures in regards to management's representations, especially in relation to anticipated gross profit and estimated costs to complete on work-in-progress.

On the "Disclosure Requirements Checklist," Item 2 under cash deals with material bank overdrafts presented as a separate caption amount current liabilities. Per review of the trial balance, it appears that CCI had an operating account and a payroll account with overdrawn balances as of December 31, 1997, and a cash management account with a balance that exceeded the two overdrawn cash accounts. Therefore, the possibility exists that the proper financial statement presentation would be to show the cash management account as an asset and the two overdrawn accounts as a current liability. Or, if in fact the overdrawn balance was caused by held checks, Brown Schultz should have considered adding back the held checks to cash and increasing accounts payable by that same amount. Brown Schultz noted that this issue was "N/A" with a handwritten statement that the material bank overdrafts were netted with the cash

management account. Although this presentation issue would not effect the "bottom line"; net income and retained earnings, it would effect such critical items as current assets, total assets, and the current ratio. Therefore, Brown Schultz should have checked this issue as "Yes" and considered presenting it as an asset and a current liability.

There appear to be significant errors regarding the confirmation of receivables and treatment of the results obtained. For example, there appears to have been a material difference noted on the "DGS 373-1.1" job (Job #439, Mahonoy Prison) between what was represented on CCI's books and what the owner confirmed. CCI's books overstated the revised contract amount by \$10,623. (This appears to have related to change orders as CCI recognized \$183,782 of change orders while only \$173,159 was confirmed by the owner; a difference of \$10,623). CCI's books overstated totaled billings to date by \$586,467. CCI's books also overstated accounts receivable ("current") by \$176,476. (This appears to have been offset by CCI's understatement of retention by approximately the same amount). On their working papers analyzing the response from the owner, it appears that Brown Schultz incorrectly attempted to reconcile the above-detailed variances.

In regards to the \$586,467 variance in regards to billings, it was noted by Brown Schultz that the amount confirmed by the owner excluded retention in the amount of \$366,592. However, nowhere was it documented how this assertion was determined. In addition, assuming that Brown Schultz' assertion was accurate concerning retention, there still existed a difference in the amount of \$219,875.

In regards to the variance in current receivables, Brown Schultz documented that the \$219,875 variance noted in regards to billings was the same variance noted in regards to the receivables. However, Brown Schultz went on to conclude that these two variances would have

no income statement effect. Rather, it would simply be a debit to the overbillings account (liability) and a credit to the receivables account (asset) in the amount of \$219,875. Therefore, no adjustment was made. There are a number of issues raised by this conclusion. Assuming Brown Schultz was correct in simply offsetting the two accounts, it appears that the entry should have been booked since the decrease of assets and liabilities may have effected such items as total assets, total current assets, and the current ratio. This, in turn, may have had an impact on bank and surety underwriting decisions. Moreover, this variance may have been an indication of weaknesses within CCI's internal financial reporting. Nowhere is the reason for the variance documented. In addition, nowhere is it documented why Brown Schultz felt it was not necessary to expand their audit procedures in regards to the billing and receivable functions.

Regarding the confirming of receivables, there also appears to have been a material difference noted on the "DGS 579-3.1" job (Job #445, Houtzdale Prison) between what was represented on CCI's books and what the owner confirmed. CCI's books overstated totaled billings to date by \$357,706. CCI's books overstated accounts receivable ("current") by \$94,726. CCI's books overstated retention by \$6,174. On the working papers analyzing the response from the owner, it appears that Brown Schultz incorrectly attempted to reconcile the above-detailed variances.

In regards to the \$357,706 difference in regards to billings, Brown Schultz noted that the amount confirmed by the owner excluded retention in the amount of \$254,806. However, nowhere was it documented how this assertion was determined. In addition, assuming that Brown Schultz' assertion was accurate concerning retention, there still existed a difference in the amount of \$102,900.

In regards to the variance in current receivables, Brown Schultz noted that the \$102,900 variance noted in regards to billings was the same variance noted in regards to the receivables. However, Brown Schultz went on to conclude that these variances would have no income statement effect. Rather, it would simply be a debit to the overbillings account (liability) and a credit to the receivables account (asset) in the amount of \$102,900. Therefore, no adjustment was made. There are a number of issues raised by this conclusion. Assuming Brown Schultz was correct in simply offsetting the two accounts, it appears that the entry should have been booked since the decrease of assets and liabilities may have effected such items as total assets, total current assets, and the current ratio. This, in turn, may have had an impact on bank and surety underwriting decisions. Moreover, this variance may have been an indication of weaknesses within CCI's internal financial reporting. Nowhere is this fact documented and nowhere is it documented why Brown Schultz felt it was not necessary to expand their audit procedures in regards to the billing and receivable functions.

It should be noted that there were significant errors based upon the receipt of the confirmations (together, totaling in excess of \$320,000), that should have been an indication to Brown Schultz that there were significant deficiencies in CCI's financial cost systems for recording, among other things, job-related receivables, retention and overbillings.

Brown Schultz also erred in the treatment of indirect costs; namely, the presentation of the financial statements in relation to indirect costs appears not to be in accordance with GAAP. It appears that costs of contracts for each individual contract as represented on the "Earnings from Contracts," "Completed Contracts" and "Contracts-in-Progress" schedules included only direct costs (direct material, labor, subcontracting, and other direct costs); indirect costs and general and administrative expenses are charged to expense as incurred. (See Note 1 to the

financial statements.) However, GAAP (see SOP 81-1) requires all indirect costs to be allocated to individual contracts using a reasonable method. Therefore, GAAP does not allow a line item "Indirect Costs" to appear on the financial statements. The result of this departure from GAAP is that actual/estimated gross profit of each individual contract represented on the "Completed Contracts" and "Contracts-in-Progress" was overstated by the amount of indirect cost that should have been allocated to that job.

It does not appear that job site visits were performed or even considered when the audit was planned. Since this procedure was not performed (nor were confirmation letters set to subcontractors), there was virtually no independent confirmation or other verification of management's representations concerning the percentage of completion, the estimated costs to complete as of the balance sheet date, and the status of pending (unapproved) change orders. Nor was Brown Schultz able to obtain any independent verification of problems on the jobs that might not have been disclosed by management (with the exception of the confirmations received from the owners). It would also appear that in the particular situation of CCI, with jobs located in many different states, there is little question that Brown Schultz would have gained a much better knowledge of CCI's operations if job site visits were in fact performed. This would be especially critical since the compensation of CCI's key personnel (Shane Miller and Sherri Phillips) was affected by the amount of gross profit on jobs and net income recognized.

INTERROGATORY NO. 9

Identify all documents which support your contention that Brown Schultz's Audit Report for the year ended December 31, 1997 was inaccurate, contained omissions and/or was misleading.

ANSWER NO. 9

USF&G objects to this interrogatory on the grounds that it is impossible at this early stage of this legally and factually complex litigation to state in full detail the basis for any contention for which some, if not much, of the factual support lies in the hands of persons other than USF&G. In essence, this and the following contention interrogatories call upon USF&G to recite each and every fact, including each communication and document that would support each and every assertion in the Complaint. As such, they are an improper use of interrogatories under the Federal Rules of Civil Procedure. However, USF&G is providing responses to this interrogatory based, for the most part, on information known or available to them at this time. These responses do not include or incorporate information that will be obtained in the course of discovery.

Without waiver of the general and foregoing objections, USF&G will make such documents available for inspection and copying at a reasonable time and place pursuant to Fed. R. Civ. P. 33(d). Such documents consist, in the main, of Brown Schultz' working papers, the audit and tax file, correspondence and the appropriate audit reports, all of which were previously produced by Brown Schultz.

INTERROGATORY NO. 10

For each inaccuracy and/or omission identified in response to interrogatory No. 8, is it your contention that it was material to the issuance of the payment and performance bonds identified in Paragraph 18 of the Complaint? If so, state the factual basis for your contention and the sources of proof for the facts which support your contention.

ANSWER NO. 10

USF&G objects to this interrogatory on the grounds that it is impossible at this early stage of this legally and factually complex litigation to state in full detail the basis for any contention

for which some, if not much, of the factual support lies in the hands of persons other than USF&G. In essence, this and the following contention interrogatories call upon USF&G to recite each and every fact, including each communication and document that would support each and every assertion in the Complaint. As such, they are an improper use of interrogatories under the Federal Rules of Civil Procedure. USF&G also states that the interrogatory is duplicative of information to be provided in expert reports which, pursuant to the Case Management Order dated August 17, 2001, are due on July 1, 2002. However, USF&G is providing responses to this interrogatory based, for the most part, on information known or available to them at this time. These responses do not include or incorporate information that will be obtained in the course of discovery and USF&G reserves the right to amend its responses to reflect such information.

USF&G relied upon the unqualified opinion contained in the audit report in its decision as to the nature and extent of the bonding program it gave to CCI. The errors or omissions discussed in interrogatory 8 resulted in the audit report inaccurately reflecting CCI's true financial condition and numerous risks inherent in the maintenance of a bonding program. Since USF&G would not have issued the bonding program to CCI which it did if the inaccuracies contained in the 1996 Audit Report were known by USF&G, all inaccuracies referred to in the response to interrogatory no. 8 are material because of the cumulative effect they had on the accuracy of the audit.

INTERROGATORY NO. 11

Is it your contention that defendants should have known of each of the inaccuracies and/or omissions identified in response to interrogatory no. 8 above? If so, state the factual basis for your contention and the sources of proof for the facts which support your contention.

ANSWER NO. 11

USF&G objects to this interrogatory on the grounds that it is impossible at this early stage of this legally and factually complex litigation to state in full detail the basis for any contention for which some, if not much, of the factual support lies in the hands of persons other than USF&G. In essence, this and the following contention interrogatories call upon USF&G to recite each and every fact, including each communication and document that would support each and every assertion in the Complaint. As such, they are an improper use of interrogatories under the Federal Rules of Civil Procedure. However, USF&G is providing responses to this interrogatory based, for the most part, on information known or available to them at this time. These responses do not include or incorporate information that will be obtained in the course of discovery and USF&G reserves the right to amend its responses to reflect such information.

In that, *inter alia*, the errors and omissions identified in response to interrogatory 4 were apparent to USF&G upon review of the working papers and could likely have been either eliminated or avoided by the implementation of procedural and substantive steps mandated by GAAP and reasonable professional standards of practice, Brown Schultz either knew or should reasonably have known of such inaccuracies and omissions.

INTERROGATORY NO. 12

State the factual basis for your contention that Brown Schultz's Audit Report for the year ended December 31, 1998 was inaccurate, contained omissions and/or was misleading including but not limited to:

- a. The nature of each inaccuracy and/or omission contained in the 1998 Audit Report; and
- b. The manner in which the 1998 Audit Report was misleading.

ANSWER NO. 12

USF&G objects to this interrogatory on the grounds that it is impossible at this early stage of this legally and factually complex litigation to state in full detail the basis for any contention for which some, if not much, of the factual support lies in the hands of persons other than USF&G. In essence, this and the following contention interrogatories call upon USF&G to recite each and every fact, including each communication and document that would support each and every assertion in the Complaint. As such, they are an improper use of interrogatories under the Federal Rules of Civil Procedure. USF&G also states that the interrogatory is duplicative of information to be provided in expert reports which, pursuant to the Case Management Order dated August 17, 2001, are due on July 1, 2002. However, USF&G is providing responses to this interrogatory based, for the most part, on information known or available to them at this time. These responses do not include or incorporate information that will be obtained in the course of discovery and USF&G reserves the right to amend its responses to reflect such information. Additionally, the instant response focuses on major inadequacies of the audited financial statements for CCI for the year ended December 31, 1998 (the "1998 Audit Report") and is not intended to be a complete recitation of all inaccuracies, omissions and representations contained therein.

USF&G further states that some of the inaccuracies and omissions are relevant only when viewed in the context of other audits of CCI performed by Brown Schultz. Accordingly, USF&G incorporates herein by reference the responses to interrogatories nos. 4 and 8 as if fully set forth herein.

As part of the statements that were issued for the year ended December 31, 1998, the statement, as originally reported, contained current assets of \$17.8 million, other assets of \$6.8

million, total liabilities of \$19.3 million and equity of \$5.3 million. As restated, the current assets were \$13.0 million, other assets were \$6.8 million, liabilities were \$20.1 million and equity was a negative \$.3 million. The net effect of this is that retained earnings as originally reported were overstated by \$5.6 million.

There was profit fade of \$5.0 million on the work in process as of December 31, 1998. By overstating the estimated profit on these jobs Brown Schultz had materially overstated overbillings and net income for 1998. Brown Schultz did not properly allocate indirect costs and did not properly perform an audit of construction contracts in accordance with GAAS.

Form B-2; Part 1, "Checklist for Evaluating Business Risk and Overall Inherent and Audit Risk"; question 25 dealing with the safeguarding of assets, segregation of duties, management approvals and the oversight function, it appears that Brown Schultz improperly checked this off as "N/A." The fact that CCI was working in many different states where centralized management and strong central control over assets was not as strong as if all the work was performed near their Harrisburg office, Brown Schultz should have checked this questions as "YES" and considered this issue when planning the audit. This should have been a significant factor to be considered by Brown Schultz when planning the audit.

Included in Brown Schultz' working papers was the Guaranty Agreement dated December 1, 1998 between the Company and PCIC. Included in the agreement was the following: "PCIC will guarantee the claim that was filed by CCI in the amount of . . . \$1,200,000 with the Department of General Services, Commonwealth of Pennsylvania, for the project known as Mahanoy State Correctional Institution If the Department of General Services, Commonwealth of Pennsylvania, fails to pay all of any part of the subject claim, PCIC will pay the difference owing or the full amount of the claim if no part of the claim is paid." The

following are observations concerning this agreement and its impact on the 1998 financial statements:

(a) Although it was disclosed in the financial statements (under related party transactions) that PCIC is an entity owned by the sole shareholder of CCI, John Ortenzio, this fact was not documented in the working papers.

(b) Nowhere was it documented, either in the planning phase or in any of the audit programs if consideration should have been made in determining if PCIC had the financial resources to pay this claim to CCI.

Assuming, *arguendo*, that Brown Schultz was correct in recognizing the claim as income in 1998, there appears to have been significant disclosure issues. These include that the amount of the claim was included as an "underbilling" (costs and estimated earnings in excess of billings). GAAP requires that this amount be disclosed as a "claim receivable."

Additionally, the following should have been disclosed in regards to this receivable (see AICPA Guide, para. 6.24 and SOP 81-1, para. 65):

- (a) The total receivable;
- (b) A description of the nature of the status of the principal items comprising the amount;
- (c) The portion, if any, expected to be collected after one year; and
- (d) Revenues from claims recognized.

It should be noted that property and equipment was a much more significant asset in 1998 than in 1997. In 1997, net property comprised approximately 8.7% of total assets, while in 1998, this percentage increased to approximately 27.5%. However, nowhere is it documented that

Brown Schultz expanded its audit testing in this area as the result of the increased significance of these assets.

Included in the Permanent File was an employment agreement dated October 3, 1997 between the Company and Shane A. Miller, CCI's Executive Vice-President and the individual responsible for field operations. This agreement provided for bonus incentives to be paid to Mr. Miller based upon CCI's net operating income. Essentially, the higher CCI's net income the higher Mr. Miller's bonus would be. Therefore, Brown Schultz should have planned the audit with the expectation that CCI's management would tend to overstate net income in order to realize the bonus. Moreover, this may be a possible explanation for the profit fade recognized by CCI subsequent to December 31, 1998 from represented amounts previously recognized.

Brown Schultz also erred relative to its treatment of the inclusion of at least a significant portion of unapproved (pending) change orders. There did not appear to be proper documentation for the inclusion of approximately \$500,000 of this amount, according to GAAP. In addition, assuming, *arguendo*, that Brown Schultz was correct in recognizing the unapproved change orders, there was not proper disclosure of the approximately \$600,000 of unapproved change orders included in the 1998 statements. Rather, it appears Brown Schultz simply "buried" these unapproved change orders together with underbillings and overbillings without proper disclosure.

In general, virtually no audit testing was performed in regards to verifying management's representations of costs to complete.

GAAP (SOP-81-1, para. 88) requires that provisions for losses on contracts be shown separately as liabilities on the balance sheet. Per the 1998 financial statements, included in the work-in-progress schedule, one job-in-progress (job #451, Lord Fairfax) was projected to incur a

loss of approximately \$218,000. However, nowhere in the liability section of the balance sheet is this reflected. Rather, Brown Schultz noted on page 5 of the "Supplemental Disclosure Requirement-Construction" checklist indicates that the loss was included in the work-in-progress adjustment.

The 1998 financial statements ("Contracts-in-Progress" schedule) reflects an underbilling amount (Costs and estimated earnings in excess of billings) in excess of \$6,300,000. Most of these underbillings relate to the following jobs:

<u>Job #</u>	<u>Job Name</u>	<u>Amount</u>
439	Mahonoy Prison	\$1,216,401
450	Johnstown	\$ 449,818
454	Albermarle Prison	\$ 717,560
455	Perry Point	\$2,234,503
460	Germ Plasma Center	\$ 831,756
461	Outlook-Chesterfield	\$ 509,709

However, nowhere in the working papers was it documented that these significant underbillings were analyzed for reasonableness and the likelihood that CCI would eventually be able to bill the applicable owner these amounts.

In regards to the confirming of receivables, there appears to have a significant amount of unapproved (pending) change orders recorded as income in regards to the Lord Fairfax job (Job # 451) in the amount of \$108,653.

In summary, CCI booked the following unapproved (pending) change orders as of December 31, 1998:

<u>Job #</u>	<u>Job Name</u>	<u>Amount</u>
454	Albemarle	\$279,334
455	Perry Point	107,846
426	U.E.P.H. Complex	88,731
449	U.E.P.H. Headquarters	21,086
460	Germ Plasma Center	65,000
459	Scott Air Force Base	17,993
451	Lord Fairfax	<u>108,653</u>
TOTAL		<u>\$688,643</u>

Brown Schultz documented its research into unapproved change orders as follows (from a "review" of the AICPA Audit and Accounting Guide for Construction Contractors):

"For all unpriced change orders, recovery should be deemed probable if the future event or events necessary for recovery are likely to occur. Some of the factors to consider in evaluating whether recover is probable are the customer's written approval of the scope of the change order, separate documentation for change order costs that are identifiable and reasonable, and the entity's favorable experience in negotiating change orders, especially as it relates to the specific type of contract and the change order being evaluated."

"If it is probable that the contract price will be adjusted by an amount that exceeds the costs attributable to the change order and the amount of the excess can be reliably estimated, the original contract price should also be adjusted for that amount when the costs are recognized as costs of contract performance if its realization is probable. Revenue in excess of the costs attributable to unpriced change orders should only be recorded in which realization is assured beyond a reasonable doubt, such as circumstances in which realization is assured beyond a reasonable doubt, such as circumstances in which an entity's historical experience provides such

assurance or in which an entity has received a bona fide pricing offer from a customer and records only the amount of the offer as revenue.”

Brown Schultz went on to document that, “[p]er discussion with Stan Sechrist, V.P. of Operations, CCI is very conservative and will only add pending (unapproved) change orders to the contract amount if they are certain they will be approved. In the past, CCI has not had any significant problems payment for any change orders (approved or unapproved).”

Finally, Brown Schultz documented that, “[p]er review of the prior year workpapers, the *majority* (emphasis added) of pending change orders recorded as of 12/31/97 had been authorized by the owner subsequent to the year end.”

The following indicate possible errors in the booking of unapproved change orders by CCI as of and for the year ended December 31, 1998:

(1) In prior years, it had not been CCI’s practice to book and recognize unapproved change orders. This, in turn, assuming, *arguendo*, that CCI was correct in recognizing these unapproved change orders, and assuming there were unapproved/pending change orders in prior years which were not recognized until 1998, probably caused a distortion of 1998 income.

(2) It is not clear what Brown Schultz intended to document by stating that “the *majority* of pending change orders recorded as of 12/31/97 had been authorized by the owner subsequent to the year end.” (emphasis added). If the amount ultimately authorized was only 51% of the total population (majority), then Brown Schultz may have had to modify this representation. In addition, it is not clear what audit procedures (if any) were performed on prior year pending change orders in order to formulate this conclusion (with the exception of “reviewing prior year workpapers” and inquiries of some members of management).

(3) To be able to book an unapproved change order, consideration must be made of whether the change order has been priced and whether the price and scope have been approved by the owner.

Summarily, based solely on documentation provided by Brown Schultz, the following pending change orders appear to not have been recorded in accordance with GAAP:

<u>Job #</u>	<u>Job Name</u>	<u>Amount</u>
454	Albemarle	\$279,334
455	Perry Point	107,846
460	Germ Plasma Center	65,000
459	Scott Air Force Base	17,993
451	Lord Fairfax	<u>31,742</u>
TOTAL		<u>\$501,915</u>

Accordingly, it appears that Brown Schultz may have overstated revenues and net income by approximately \$501,915. (This would give Brown Schultz "credit" for U.E.P.H. Complex in the amount of \$88,731, U.E.P.H. Headquarters in the amount of \$21,086, and a portion of Lord Fairfax in the amount of \$76,944.) However, even under the assumption that GAAP would have permitted recognizing these pending change orders as of and for the year ended December 31, 1998, the following were required to be disclosed in the 1998 financial statements:

- (1) The total receivable;
- (2) A description of the nature and status of the principal items comprising the amount;
- (3) The portion, if any, expected to be collected after one year; and
- (4) Revenues from claims recognized.

It appears that Brown Schultz did not disclose any of the above, but simply "buried" the amounts of the pending change orders together with underbillings and overbillings reported on other jobs.

In Brown Schultz' audit program concerning completed contracts, the procedure used was as follows: "Selected two jobs included in the completed contract listing . . . which were between 40% and 80% complete in the prior year, in order to get a good test of the client's estimating procedures." It was not documented why Brown Schultz did not choose jobs that were less than 40% or greater than 80% complete of December 31, 1997. It appears that this test should have been expanded to include jobs in various stages of completion as of December 31, 1997 in order to analyze CCI's estimating ability in regards to location, project manager, type of work, etc. This analysis should then have been used for determining the reasonableness of management's representations as of December 31, 1998. Therefore, Brown Schultz' conclusions that based on analyzing two jobs completed in 1997 that were between 40% and 80% complete as of December 31, 1997, the client's estimating procedures were consistent with the prior years may have been flawed.

In relation to the testing of CCI's job cost system, it appears that only the following procedures were performed:

- 25 job cost items (12 related to payroll and 13 related to other costs) were "haphazardly" selected and testing. This testing included:
 - (a) Obtaining the purchase and payroll journals for the year;
 - (b) Requesting the Company provide the appropriate documentation for the job costs "haphazardly" selected (i.e., purchase order and invoice), subcontract agreement, timesheet, etc.; and
 - (c) Ascertaining that the cost was coded to the correct job by review of source documentation and job cost history reports.

Brown Schultz did not document why testing only 25 items was adequate in expressing their opinion. In addition, nowhere was the definition of a "haphazard" sample documented nor is there documentation concerning what procedures were employed by Brown Schultz to determine which individual items of the population were sampled.)

The obtaining of the summary of contracts as of December 31, 1998 also appears flawed. This schedule should include what would normally be found on a contractor's work-in-progress schedule. However, the audit program did not detail any audit procedures Brown Schultz was to perform on this schedule.

There also appears to be error regarding obtaining of the contracts in progress at the balance sheet date. From this schedule, the auditor was to perform the following tasks:

- (1) Determine which jobs were in process at year-end based upon percentage of completion and discussion with the client. The program instructed the auditor to exclude contracts greater than 97% complete or less than 3% started.
- (2) For substantially completed contracts, the program instructed the auditor to verify that no significant costs were recorded after year-end. Also the auditor was instructed to verify with the client that the job was substantially complete. It should be noted that Brown Schultz documented that "[a]ll necessary costs were accrued as 12/31/98 and the jobs were listed in the completed contract listings." However, nowhere was it documented what testing was performed by Brown Schultz to reach this conclusion.

There was also error regarding obtaining of signed contract and change orders in that there was a failure to note agreement as to job number, job name and contract amount.

CCI was improperly omitting some of the indirect costs from the cost of each individual contract in 1998. This omission had the effect of overstating gross profit for each individual

contract in progress and completed by the amount of allocable indirect costs that should have been allocated.

In addition, it does not appear that projected indirect costs needed to complete the jobs were included in management's estimated costs to complete as of December 31, 1998.

Both GAAP and tax rules require that indirect costs be allocated to contracts, regardless of whether the percentage-of-completion or completed-contract method is used. Moreover, a significant error in the allocation of indirect costs could indicate a major problem with the company's bidding procedures (management may be bidding contracts at a loss). Also, Brown Schultz should have noted that indirect costs must also have been allocated to estimated costs to complete for all contracts still in progress as of December 31, 1998, 1997, and 1996.

It appears that Brown Schultz performed limited testing on the adequacy of management's estimate of costs to complete included on the work in progress. These procedures included comparing actual costs incurred subsequent to year-end and estimated costs to complete as of December 31, 1998 and comparing original estimates and total estimated costs to complete the job. In regards to the second procedure detailed above (comparing original estimates and total estimated costs to complete the job), it appears that Brown Schultz tested all ten jobs-in-progress. This test produced the following results in regards to the gross profit percentage as originally estimated, the gross profit percentage as of December 31, 1998 ("WIP"), and the amount of profit increase (slippage) recognized between the time the job was originally bid and as of December 31, 1998:

<u>Job #</u>	<u>Original Projection %</u>	<u>"WIP" @12/31/98 %</u>	<u>Dollar amount of Increase (Slippage)</u>
454	6.63%	11.35%	\$764,754
460	2.78%	5.77%	\$466,976
450	1.46%	.66%	(\$26,064)
451	10.11%	(3.08%)	(\$914,055)
461	6.24%	5.53%	(\$27,840)
456	10.98%	10.77%	(\$4,776)
462	6.73%	6.65%	(\$4,310)
455	9.09%	11.39%	\$313,189
459	7.43%	6.33%	(\$76,784)
439 (A)	(.41%)	(4.06%)	(\$374,578)

On each page of the analysis, Brown Schultz attempted to explain these significant "swings" (which appear to have gone "both ways" in regards to gross profit). However, none of the explanations provided documentation that inquiries were made of project managers associated with each job.

In addition, the fact that large variances between original projections and current represented results (while the job was still in progress) should have been an indication to Brown Schultz that further inquiries and audit procedures should have been performed.

Included in the 1998 working papers was one titled "CCI Construction Management Work-in-Progress" (BSSF 2075). Detailed on this schedule were billings and costs incurred in 1998 in regards to contracts that were considered completed during 1997. This schedule documents that overstated costs were understated. The 1998 income statement impact of these billings and cost errors are as follows:

Overstated revenue	\$111,935
Understated costs	<u>\$148,743</u>
Total overstatement of 1997 net income	<u>\$260,678</u>

On the "Disclosure Requirement" checklist, page -23-, question 8 deals with the inclusion of a "Going Concern" disclosure in the financial statements. SAS No. 59 (AU 341.02) requires the auditor to "evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited." A contractor's inability to complete contracts or obtain required performance bonds would be a serious indication of a going concern problem. The auditor should consider whether information obtained from audit procedures applied during the audit identifies conditions and events that indicate there could be substantial doubt about the contractor's ability to continue as a going concern for a reasonable period of time. Examples of conditions and events which may have applied to the Company as of December 31, 1998 indicating a possible substantial doubt about CCI's ability to continue as a going concern include, without limitation, the following:

- (1) Negative trends such as recurring operating losses, working capital deficiencies, and declining backlog levels;
- (2) Internal matters such as labor difficulties, substantial dependence on the success of a particular contract, and loss of key people;
- (3) External matters such as denial of a surety bond, significant legal proceedings, and environmental legislation with potential adverse effects; and
- (4) Projected negative cash flow on the Company's jobs-in-progress as of the balance sheet date.

Generally, if a contractor incurs substantial losses on contracts that have been front-end loaded (thereby creating significant "overbillings"), a cash deficiency toward the end of those contracts may be experienced. The deficiency may prevent the contractor from meeting current

obligations, and the contractor may have to front-end load new contract in order to generate funds to meet those obligations. The necessity to generate cash may cause the contractor to accept jobs that are only marginally profitable. This issue is specifically discussed in the AICPA Guide at Paragraph 11.11. It appears that Brown Schultz took none of the foregoing into account in planning or conducting its audit, particularly as regards going-concern disclosures.

It does not appear that job site visits were performed or even considered when the audit was planned. Since this procedure was not performed (nor were confirmation letters sent to subcontractors), there was virtually no independent confirmation or other verification of management's representations concerning the percentage of completion and the estimated costs to complete as of the balance sheet date. Nor was Brown Schultz able to obtain any independent verification of problems on the jobs that might not have been disclosed by management (with the exception of the confirmations received from the owners).

Brown Schultz also erred in the treatment of indirect costs; namely, the presentation of the financial statements in relation to indirect costs appears not to be in accordance with GAAP. It appears that costs of contracts for each individual contract as represented on the "Earnings from Contracts," "Completed Contracts" and "Contracts-in-Progress" schedules included only direct costs (direct material, labor, subcontracting, and other direct costs); indirect costs and general and administrative expenses are charged to expense as incurred. (See Note 1 to the financial statements.) However, GAAP (see SOP 81-1) requires all indirect costs to be allocated to individual contracts using a reasonable method. Therefore, GAAP does not allow a line item "Indirect Costs" to appear on the financial statements. The result of this departure from GAAP is that actual/estimated gross profit of each individual contract represented on the "Completed

Contracts” and “Contracts-in-Progress” was overstated by the amount of indirect cost that should have been allocated to that job.

INTERROGATORY NO. 13

Identify all documents which support your contention that Brown Schultz’s Auditor’s Report for the year ended December 31, 1998 was inaccurate, contained omissions and/or was misleading.

ANSWER NO. 13

USF&G objects to this interrogatory on the grounds that it is impossible at this early stage of this legally and factually complex litigation to state in full detail the basis for any contention for which some, if not much, of the factual support lies in the hands of persons other than USF&G. In essence, this and the following contention interrogatory call upon USF&G to recite each and every fact, including each communication and document that would support each and every assertion in the Complaint. As such, they are an improper use of interrogatories under the Federal Rules of Civil Procedure. However, USF&G is providing responses to this interrogatory based, for the most part, on information known or available to them at this time. These responses do not include or incorporate information that will be obtained in the course of discovery.

Without waiver of the general and foregoing objections, USF&G will make such documents available for inspection and copying at a reasonable time and place pursuant to Fed. R. Civ. P. 33(d). Such documents consist, in the main, of Brown Schultz’ working papers, the audit and tax file, correspondence and the appropriate audit reports, all of which were previously produced by Brown Schultz.

INTERROGATORY NO. 14

For each inaccuracy and/or omission identified in response to interrogatory No. 12, is it your contention that it was material to the issuance of the payment and performance bonds identified in Paragraph 20 of the Complaint? If so, state the factual basis for your contention and the sources of proof for the facts which support your contention.

ANSWER NO. 14

USF&G objects to this interrogatory on the grounds that it is impossible at this early stage of this legally and factually complex litigation to state in full detail the basis for any contention for which some, if not much, of the factual support lies in the hands of persons other than USF&G. In essence, this and the following contention interrogatories call upon USF&G to recite each and every fact, including each communication and document that would support each and every assertion in the Complaint. As such, they are an improper use of interrogatories under the Federal Rules of Civil Procedure. USF&G also states that the interrogatory is duplicative of information to be provided in expert reports which, pursuant to the Case Management Order dated August 17, 2001, are due on July 1, 2002. However, USF&G is providing responses to this interrogatory based, for the most part, on information known or available to them at this time and USF&G reserves the right to amend its responses to reflect such information. These responses do not include or incorporate information that will be obtained in the course of discovery.

USF&G relied upon the unqualified opinion contained in the audit report in its decision as to the nature and extent of the bonding program it gave to CCI. The errors or omissions discussed in interrogatory 4 resulted in the audit report inaccurately reflecting CCI's true financial condition and numerous risks inherent in the maintenance of a bonding program. Since USF&G would not have issued the bonding program to CCI which it did if the inaccuracies contained in the 1996 Audit Report were known by USF&G, all inaccuracies referred to in the

response to interrogatory no. 12 are material because of the cumulative effect they had on the accuracy of the audit.

INTERROGATORY NO. 15

Is it your contention that defendants should have known of each of the inaccuracies and/or omissions identified in response to interrogatory no. 12 above? If so, state the factual basis for your contention and the sources of proof for the facts which support your contention.

ANSWER NO. 15

USF&G objects to this interrogatory on the grounds that it is impossible at this early stage of this legally and factually complex litigation to state in full detail the basis for any contention for which some, if not much, of the factual support lies in the hands of persons other than USF&G. In essence, this and the following contention interrogatories call upon USF&G to recite each and every fact, including each communication and document that would support each and every assertion in the Complaint. As such, they are an improper use of interrogatories under the Federal Rules of Civil Procedure. However, USF&G is providing responses to this interrogatory based, for the most part, on information known or available to them at this time. These responses do not include or incorporate information that will be obtained in the course of discovery and USF&G reserves the right to amend its responses to reflect such information.

In that, *inter alia*, the errors and omissions identified in response to interrogatory 4 were apparent to USF&G upon review of the working papers and could likely have been either eliminated or avoided by the implementation of procedural and substantive steps mandated by GAAP and reasonable professional standards of practice, Brown Schultz either knew or should reasonably have known of such inaccuracies and omissions.

INTERROGATORY NO. 16

Identify all persons whom USF&G expects to call as expert witnesses at the trial of this action and describe their training, experience, employments history, educational background and fields of expertise.

ANSWER NO. 16

Without waiver of the general objections, USF&G states that it has not yet decided whom it will call as expert witnesses at the trial of this action. USF&G will identify such individuals in accordance with the appropriate provisions of the Case Management Order.

INTERROGATORY NO. 17

With regard to each person listed in response to the preceding interrogatory describe with specificity:

- a. the subject matter upon which each expert is expected to testify at the time of trial;
- b. the substance of the facts and opinions to which the expert is expected to testify;
and
- c. a summary of the grounds of each opinion.

ANSWER NO. 17

Without waiver of the general objections, USF&G states that it has not yet decided whom it will call as expert witnesses at the trial of this action. USF&G will identify such individuals in accordance with the appropriate provisions of the Case Management Order.

Anthony Phillips, being first duly sworn, deposes and says that he is authorized by USF&G to respond to the foregoing Interrogatories; that while he does not have personal knowledge of all of the facts recited in the foregoing responses, the information contained therein has been collected and made available to him by others, and the responses to the interrogatories are true to the best of his knowledge and belief based upon the information made available to him.

UNITED STATES FIDELITY &
GUARANTY COMPANY,

Anthony Phillips
By _____
Its duly authorized:

COMMONWEALTH OF PENNSYLVANIA

_____, ss.

December 11, 2001

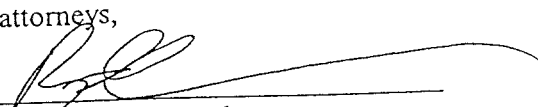
Then personally appeared the above-named Anthony Phillips, duly authorized representative of United States Fidelity & Guaranty Company and acknowledged the foregoing instrument to be the free act and deed of said corporation, before me.

M. Violante
NOTARY PUBLIC
Print Name: _____
My Commission expires: _____

Notarial Seal
Joan M. Violante, Notary Public
Whitpain Twp., Montgomery County
My Commission Expires Nov. 22, 2003

AS TO OBJECTIONS:

UNITED STATES FIDELITY
& GUARANTY COMPANY,
By its attorneys,



Peter B. McGlynn, Esquire
Bruce D. Levin, Esquire
Bernkopf, Goodman & Baseman LLP
125 Summer Street, Suite 1300
Boston, MA 02110
Telephone: (617) 790-3000

and

Jeffrey Rettig, Esquire
Thomas, Thomas & Hafer
305 North Front Street
Harrisburg, PA 17101
Telephone: (717) 237-7100

Dated: December 7, 2001
#233259 v1/36432/87

3

IN THE UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF PENNSYLVANIA
(HARRISBURG DIVISION)

UNITED STATES FIDELITY
AND GUARANTY COMPANY,
PLAINTIFF

v.

BRUCE J. BROWN AND BROWN,
SCHULTZ, SHERIDAN & FRITZ
DEFENDANTS

NO. 1:01 CV 00813
(JUDGE KANE)

EXPERT REPORT OF STEVE J. DeBRUYN, CPA

I am a Certified Public Accountant and am a Partner in the firm of Clifton Gunderson LLP. I also serve as the Construction Contractor Industry Group Leader for Clifton Gunderson LLP. A copy of my *Curriculum Vitae* is attached hereto as Exhibit "A." I am being compensated for my professional services at the rate of \$250 per hour.

I have been engaged by Bernkopf, Goodman & Baseman LLP to determine if I could render certain opinions concerning the audit procedures performed by and conclusions reached with respect to the audited financial statements prepared by Brown, Schultz, Sheridan & Fritz ("Brown Schultz") for CCI Construction Company, Inc. ("CCI") for the fiscal years ended December 31, 1996, 1997 and 1998. I have determined that I am able to render such opinions.

In connection with my engagement, I have reviewed the audit procedures and conclusions reached by Brown Schultz as they relate to that firm's audits of CCI for the calendar years ended in 1996, 1997 and 1998 (the "Audit Reports"). In particular, I analyzed whether the

audit procedures and conclusions conformed to Generally Accepted Accounting Principles (GAAP) and Generally Accepted Auditing Standards (GAAS).

In analyzing the Audit Reports, I have reviewed and relied upon the following documents:

- Brown Schultz' audit workpapers for CCI for the fiscal years ended December 31, 1996, 1997, & 1998.
- Brown Schultz' "Permanent File" for CCI.
- AICPA TECHNICAL PRACTICE AIDS, Statement of Position 81-1, Accounting for Performance of Construction - Type and Certain Production-Type Contracts, July 15, 1981;
- AICPA AUDIT AND ACCOUNTING GUIDE FOR CONSTRUCTION CONTRACTORS, May 1, 1997
- Statement on Auditing Standards No. 47, Audit Risk & Materiality In Conducting An Audit (American Institute of Certified Public Accountants, 1983);
- Statement on Auditing Standards No. 57. Auditing Accounting Estimates (American Institute of Certified Public Accountants, 1988);
- FAS No. 5, Accounting for Contingencies; March 1975
- FAS No. 57, Related Party Disclosures; March 1982.
- Statement on Auditing Standards No. 22, Planning and Supervision, (American Institute of Certified Public Accountants 1978).
- Statement on Auditing Standards No 31, Evidential Matter, (American Institute of Certified Public Accountants 1980).
- Depositions of Bruce J. Brown dated January 17, 2002 and a preliminary draft of

the deposition of July 19, 2002; I have also reviewed portions of the deposition of Sherri Phillips, taken on July 10, 2002, and portions of the deposition of Deborah Bowman dated May 21, 2002.

- Various pleadings filed in the above-captioned action;
- 1998 Audited Financial Statements prepared by Brown Schultz for Pennsylvania Contractors Insurance Co., Inc. ("PCIC");
- Brown Schultz' work papers for the audit of "PCIC" for the fiscal year ended December 31, 1998;
- Work in process schedule as of December 31, 1999 prepared by CCI personnel.

In general, for reasons explained below, it is my opinion that the audit work performed by Brown Schultz for CCI for the fiscal years ended December 31, 1997 and 1998 did not conform to applicable standards of care of a Certified Public Accountant and this resulted in material misstatements and omissions in Brown Schultz' 1997 and 1998 Audit Reports. Specifically, the negligent audit work performed by Brown Schultz resulted in an overstatement of both income and equity in the amount of \$815,960 for 1997 and \$3,126,508 for 1998. It is also my opinion that these misstatements were material to the financial position of CCI.

The primary causes of the material misstatements in the 1997 and 1998 Audit Reports include, but are not limited to, the following:

1. Brown Schultz' workpapers demonstrate Brown Schultz' failure to properly assess the risk involved with the audit of CCI from 1996 through 1998. Because of this failure to properly identify the risks associated with CCI, Brown Schultz' audit programs and its audit fieldwork were inadequate to provide the required assurance that the Audit Reports were fairly presented in accordance with GAAP. A primary objective of an audit is to identify high-risk

audit areas and plan the audit procedures accordingly. Brown Schultz' workpapers identified high-risk characteristics in both CCI and CCI's individual contracts. Brown Schultz' audit planning work papers for 1996, 1997 and 1998 were virtually identical to each other and did not reflect any of the increasing audit risks inherent in the CCI audit engagement. Further, the audit work performed by Brown Schultz for the fiscal years ended December 31, 1996, 1997 and 1998 did not change materially from year to year. This is significant in light of the fact that the audit risk profile of CCI was increasing in each successive year due to the following:

- A significant dollar volume of work was being performed by CCI's subcontractors.
- Brown Schultz' knowledge of and its documentation of past and present claims and defaults with respect to CCI's subcontractors;
- CCI's expansion in new geographical areas;
- The profit fades noted by Brown Schultz on contracts completed in subsequent years required Brown Schultz to question the reliability of CCI's management's ability to estimate costs-to-complete;
- At the end of 1997 and throughout 1998, CCI was self-performing some of the work which it previously subcontracted to others and purchased a substantial amount (approximately \$7 million) of construction equipment;
- CCI was not properly allocating indirect costs to individual contracts;
- The presence of significant related-party transactions.

2. There were inadequate audit procedures performed by Brown Schultz in the areas of contracts-in-progress; specifically, the design and implementation of substantive procedures in connection with accumulated costs and estimated costs to complete. In my opinion, undue

reliance was placed by Brown Schultz on CCI management's assertions with respect to costs to complete and estimated profits. The determination of the accuracy of the accumulated costs to date and the estimated costs-to-complete is critical to contractors like CCI using the percentage of completion method of accounting.

Brown Schultz acknowledged that its testing of contract costs was a test of CCI's cost controls only. This was inappropriate under the circumstances extant here. The testing of 25 costs was a test of transactions which an auditor can use to make qualitative assessments from the results. However, such testing does not replace the need to perform substantive procedures, such as vouching significant contract costs and analytical review. CCI had significant direct costs related to subcontractors and there was documentation contained in Brown Schultz' workpapers relating to past and present claims with subcontractors as well as evidence of subcontractor defaults. Nonetheless, Brown Schultz did not send out any subcontractor confirmations, nor does Brown Schultz' "Permanent Files" or its work papers demonstrate that it read any subcontracts and other similar construction agreements. In addition, Brown Schultz specifically excluded any testing of unrecorded liabilities for any job related expenses. Instead, as noted above, Brown Schultz relied on a test of 25 "haphazardly" selected costs throughout each year and there was no evidence that Brown Schultz performed any analytical procedures related to accumulated job costs.

The estimated costs-to-complete contained in the 1996, 1997 and 1998 Audit Reports were deficient in that they relied on CCI's representations with no documentation substantiating CCI's management estimates other than they had allegedly been verified by Sherri Phillips, CCI's chief financial officer and/or Stan Sechrist, CCI's Vice President - Construction Operations. In 1998, CCI was estimating gross profits on several contracts-in-progress that were

materially higher than the historical or originally projected amounts. Subsequent review revealed that these contracts had significant profit fades and one job - no. 454 - had a loss of \$957,000.00, and profit fade from the 1998 workpaper of approximately \$2,600,000. Also, Brown Schultz' 1998 workpaper files contained no evidence of any consideration of the allocation of indirect costs to estimated costs to complete despite Brown Schultz' knowledge that CCI was self performing more of its subcontract work than in the past. In addition, there was no follow - up between the documented preliminary analytical review work and the final work, despite a material increase in the net over/underbillings. Brown Schultz also failed to document the reasons for the significant underbillings reported at the end of the 1998 year.

There was no evidence in Brown Schultz' workpapers for the 1996, 1997 and 1998 Audit Reports that Brown Schultz read one or more of the contracts for guarantees, penalty and incentive provisions or cancellation and postponement provisions.

3. There was inappropriate recording and inadequate disclosure of related-party transactions between PCIC and CCI. It is my opinion that Brown Schultz sanctioned the recording of \$1,162,460 of revenue in 1998 from PCIC, a related-party to CCI. The transaction involved the guarantee or insurance of a third party contract claim by PCIC; a company owned by the sole owner of CCI. Brown Schultz also performed the audit work on PCIC. The third party contract claim did not meet the recognition standards set forth in SOP 81-1, and in my opinion the guarantee by the related party did not support the recognition of revenue. In addition, the recording and disclosure of the third party transaction was misleading to the user of the 1998 Audit Report. Further, the related-party transaction was recorded as an underbilling instead as a separate line item on the balance sheet. The result was a material misstatement to the 1998 Audit Report of \$1,162,460.

In summary, Brown Schultz' workpapers demonstrated that undue reliance was placed on CCI management's assertions; the workpapers fail to demonstrate adequate independent verification, and do not support the conclusions reached by Brown Schultz as they relate to the Audit Reports for calendar years 1997 and 1998. In addition, Brown Schultz' workpapers have numerous other deficiencies including, without limitation, the following:

- Lack of documentation of time to indicate the partner in charge participated in the audit planning in 1998;
- The financial disclosure checklist included in the audit workpapers does not appear to be reviewed;
- Job site visits were not done and considerations not documented; and
- 1998 search for unrecorded liabilities did not go through the last day of fieldwork.

Attached hereto as Exhibit B-1 and B-2 are comparisons of CCI's Balance Sheets and Income Statements containing those adjustments warranted as a result of the defects and deficiencies in the procedures for and preparation of the Audit Reports for CCI for the fiscal years ended December 31, 1997 and 1998.

During my review of the 1996 audit workpapers, I noted that the audit procedures performed were similar to the 1997 and 1998 audits.

This report is subject to revisions based upon any other information which is obtained during discovery in the above-captioned action.

Dated: July 22, 2002
#249885 v1/JG432/87


Steve J. DeBruyn, CPA

EXHIBIT A

CURRICULUM VITAE

STEPHEN J. DEBRUYN, CPA

POSITION

Partner

EDUCATION

B.S. in Accounting
Southern Illinois University, 1982

PROFESSIONAL DESIGNATIONS

Certified Public Accountant, 1984
American Institute of Certified Public Accountants
Illinois CPA Society

LICENSES

Licensed CPA - Illinois

YEARS OF EXPERIENCE

20

PRIOR EXPERIENCE

7 years with audit staff of large regional firm. Promoted to manager in 1986, joined Clifton Gunderson June, 1989, promoted to Partner in 1993.

SUPERVISORY EXPERIENCE

Partner in charge of various audit, review and compilation engagements servicing manufacturers, contractor, retail and wholesale industries as well as employee benefit plans.

Supervision of staff on multiple concurrent engagements.

AREAS OF SPECIALIZATION

Firm-wide Construction Industry Group Leader

Audit, accounting and consulting services for various industries and employee benefit plans.

Corporate finance; merger and acquisition services.

Peer reviews and internal inspection programs.

Consulting services in connection with prospective financial statements, executive search, interpretation of financial results, succession of ownership and business valuations.

Stephen J. DeBruyn (continued)

Income tax planning and preparation for corporations, S-corporations, partnerships and L.L.C.s.

**OTHER SIGNIFICANT
EXPERIENCES IN
PUBLIC ACCOUNTING**

Advanced training through experience with previous employer in areas of audit efficiencies, documentation of accounting systems in manual or automated environments.

Speaker at annual audit and accounting conference.

Selected to the firms Leadership Career Program class of 1994.

1997 Clifton Gunderson Outstanding Performance Award.

PUBLICATIONS

Speaker at the Clifton Gunderson Annual Audit & Accounting Conference. Sessions on Construction Contractors.

October, 2000

October, 1999

October, 1998

Improved Software Keeps Construction Companies Ahead of Competitors, Clifton Gunderson LLP Relationships Magazine, Issue 6 Summer 2002.

**PREVIOUS TRIAL
EXPERIENCE**

IN RE: Marriage of Lawrence Edward Kuchefski, Petitioner and Sherri Marie Kuchefski, Respondent, Cause #99D284 Circuit Court for the 5th Judicial Circuit of Illinois located in Danville, Illinois, March 2002.

EXHIBIT B-1

CCI CONSTRUCTION COMPANY, INC.
BALANCE SHEET – DECEMBER 31, 1997

ASSETS

	<u>As Reported</u>	<u>Adjustments</u>	<u>As Restated</u>
Current assets:			
Cash and cash equivalents	\$ 1,128,337	\$ -	\$ 1,128,337
Investments in marketable securities	3,702,992	-	3,702,992
Accounts receivable, trade:			
Customers:			
Current	8,230,674	-	8,230,674
Retained	1,121,610	-	1,121,610
Shareholder	-	-	-
Affiliates	3,485	-	3,485
Note receivable	22,569	-	22,569
Costs and estimated earnings in excess of			
billings on uncompleted contracts	1,072,281	(429,978)	642,303
Prepaid expenses	6,185	-	6,185
Shop inventory	639	-	639
Total current assets	<u>15,288,772</u>	<u>(429,978)</u>	<u>14,858,794</u>
Property and equipment:			
Automobiles and trucks	427,342	-	427,342
Furniture	553,587	-	553,587
Machinery and equipment	1,323,233	-	1,323,233
Other	72,453	-	-
	<u>2,376,615</u>	<u>-</u>	<u>2,376,615</u>
Less accumulated depreciation	920,919	-	920,919
	<u>1,455,696</u>	<u>-</u>	<u>1,455,696</u>
	<u>\$ 16,744,468</u>	<u>\$ (429,978)</u>	<u>\$ 16,314,490</u>

LIABILITIES AND SHAREHOLDER'S EQUITY

	<u>As Reported</u>	<u>Adjustments</u>	<u>As Restated</u>
Current liabilities:			
Accounts payable, trade:			
Vendors:			
Current	\$ 7,846,395	\$ -	\$ 7,846,395
Retained	1,078,950	-	1,078,950
Notes payable	815,781	-	815,781
Accrued loss on jobs	-	732,685	732,685
Accrued expenses	808,601	-	808,601
Taxes withheld and accrued	58,023	-	58,023
Billings in excess of costs and estimated earnings on uncompleted contracts	<u>681,924</u>	<u>(346,703)</u>	<u>335,221</u>
Total current liabilities (all current)	<u>11,278,674</u>	<u>385,982</u>	<u>11,675,656</u>
Shareholder's equity:			
Common stock, \$1 par, 1,000 shares authorized;			
39 shares issued and outstanding	39	-	39
Capital in excess of par	9,758	-	9,758
Retained earnings	5,208,489	(815,960)	4,392,529
Unrealized gain on marketable securities	<u>236,508</u>	<u>-</u>	<u>236,508</u>
	<u>5,454,794</u>	<u>(815,960)</u>	<u>4,638,834</u>
	<u>\$ 16,744,468</u>	<u>\$ (429,978)</u>	<u>\$ 16,314,490</u>

CCI CONSTRUCTION COMPANY, INC.
STATEMENT OF INCOME
Year Ended December 31, 1997

	<u>Original</u>	<u>Adjustments</u>	<u>As Restated</u>
Revenue	\$ 34,921,676	\$ (815,960)	\$34,105,716
Cost of contracts	<u>32,617,473</u>	<u>-</u>	<u>32,617,473</u>
Gross profit	2,304,203	(815,960)	1,488,243
General and administrative expenses	<u>1,954,380</u>	<u>-</u>	<u>1,954,380</u>
Income from operations	349,823	(815,960)	(466,137)
Other income	<u>357,056</u>	<u>-</u>	<u>357,056</u>
Net income (loss)	<u>\$ 706,879</u>	<u>\$ (815,960)</u>	<u>\$ (109,081)</u>

EXHIBIT B-2

CCI CONSTRUCTION COMPANY, INC.
BALANCE SHEET – DECEMBER 31, 1998

ASSETS

	<u>As Reported</u>	<u>Adjustments</u>	<u>As Restated</u>
Current assets:			
Cash and cash equivalents	\$ 2,429,866	\$ -	\$ 2,429,866
Investments in marketable securities	631,481	-	631,481
Accounts receivable, trade:			
Customers:			
Current	5,964,311	-	5,964,311
Retained	1,822,224	-	1,822,224
Affiliates	365,756	-	365,756
Costs and estimated earnings in excess of billings on uncompleted contracts	6,341,726	(2,379,122)	3,962,604
Prepaid expenses	170,232	-	170,232
Shop inventory	38,161	-	38,161
Total current assets	<u>17,763,757</u>	<u>(2,379,122)</u>	<u>15,384,635</u>
Property and equipment:			
Automobiles and trucks	1,269,567	-	1,269,567
Furniture	851,738	-	851,738
Machinery and equipment	5,947,290	-	5,947,290
Other	344,128	-	344,128
	8,412,723	-	8,412,723
Less accumulated depreciation	1,651,485	-	1,651,485
	<u>6,761,238</u>	<u>-</u>	<u>6,761,238</u>
Other assets:			
Cash surrender value of officer's life insurance	55,453	-	55,453
Investments	34,000	-	34,000
	<u>89,453</u>	<u>-</u>	<u>89,453</u>
	<u>\$ 24,614,448</u>	<u>\$ (2,379,122)</u>	<u>\$22,235,326</u>

LIABILITIES AND SHAREHOLDER'S EQUITY

	<u>As Reported</u>	<u>Adjustments</u>	<u>As Restated</u>
Current liabilities:			
Accounts payable, trade:			
Current	\$ 10,974,274	\$ -	\$ 10,974,274
Retained	2,180,967	-	2,180,967
Current portion of long-term debt	1,338,280	-	1,338,280
Accrued loss on jobs	-	1,826,956	1,826,956
Accrued expenses	333,060	-	333,060
Taxes withheld and accrued	91,601	-	91,601
Billings in excess of costs and estimated earnings on uncompleted contracts	<u>288,208</u>	<u>(263,610)</u>	<u>24,598</u>
Total current liabilities	15,206,390	1,563,346	16,769,736
Long-term debt, net of current portion	<u>4,164,375</u>	<u>-</u>	<u>4,164,375</u>
Total liabilities	<u>19,370,765</u>	<u>1,563,346</u>	<u>20,934,111</u>
Shareholder's equity:			
Common stock, \$1 par, 1,000 shares authorized; 39 shares issued and outstanding	39	-	39
Capital in excess of par	9,758	-	9,758
Retained earnings	5,254,834	(3,942,468)	1,312,366
Accumulated other comprehensive income (loss), unrealized gain (loss) on marketable securities	<u>(20,948)</u>	<u>-</u>	<u>(20,948)</u>
Total shareholder's equity	<u>5,243,683</u>	<u>(3,942,468)</u>	<u>1,301,215</u>
Total liabilities and shareholder's equity	<u>\$ 24,614,448</u>	<u>\$ (2,379,122)</u>	<u>\$ 22,235,326</u>

CCI CONSTRUCTION COMPANY, INC.
STATEMENT OF INCOME
Year Ended December 31, 1998

	<u>Original</u>	<u>Adjustments</u>	<u>As Restated</u>
Revenue	\$ 52,534,453	\$ (3,126,508)	\$49,407,945
Cost of contracts	<u>51,145,382</u>	<u>-</u>	<u>51,145,382</u>
Gross profit	1,389,071	(3,126,508)	(1,737,437)
General and administrative expenses	<u>1,505,700</u>	<u>-</u>	<u>1,505,700</u>
Income (loss) from operations	(116,629)	(3,126,508)	(3,238,137)
Other income	<u>175,670</u>	<u>-</u>	<u>175,670</u>
Net income (loss)	<u>\$ 59,041</u>	<u>\$ (3,126,508)</u>	<u>\$ (3,067,467)</u>

UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF PENNSYLVANIA
(Harrisburg Division)

UNITED STATES FIDELITY AND
GUARANTY COMPANY,
Plaintiff

v.

BRUCE J. BROWN and BROWN
SCHULTZ SHERIDAN & FRITZ,
Defendants.

CIVIL ACTION NO. 1:01-CV-00813

JUDGE CONNOR

SUPPLEMENTAL AND REBUTTAL EXPERT REPORT OF STEVE J.
DEBRUYN, CPA

This report supplements my report dated July 22, 2002 and also addresses certain issues contained in the reports of Miller Coffey Tate LLP and The Brenner Group.

THE RESTATEMENTS IN GENERAL

My original report discloses numerous deficiencies in the audit procedures regarding the contracts in process. Therefore, to determine the potential effect on the financial statements for the respective years, I started with the contracts-in-process schedules from the supplemental financial statements of CCI Construction Company, Inc. ("CCI") prepared by Brown Schultz. The restatements for both 1997 and 1998 are a result of recasting the contracts-in-process schedules for the those years. Exhibits I and III attached hereto are the recast schedules of CCI's contract-in-process. Exhibits II and IV attached hereto are the original schedules reproduced from the audited financial statements of CCI for the respective years. Exhibit V attached hereto is the actual contracts-in-process schedule for the year ended December 31, 1999. The recast methodology used was similar to the "look back" method utilized by the Internal Revenue Service. The method involves recasting contracts-in-process in a given year from information obtained in a subsequent year. For example, if a contract was in process at the end of 1997 and subsequently completed in 1998, we recalculated, among other things, the 1997 percentage complete, revenue recognized and the profit and loss utilizing the actual numbers from the completed contract. As noted on the attached Exhibits I and III, there are a few exceptions. However, the methodology was consistently used to recast both 1997 and 1998 contracts-in-process schedule.

THE RESTATEMENT OF THE 1997 BROWN SCHULTZ AUDIT REPORT

I calculated the total estimated cost by using the "actual" gross profit percentage of the job when it was completed. There were two exceptions to this method. Job 439 was calculated estimating the loss as determined or estimated at December 31, 1997 by CCI. Job 451 was calculated using the original gross profit estimated by CCI. I then recalculated the percentage complete, which changed the over/under billings. For the 1997-year end, the effect on over/under billings and on the net income of CCI was \$815,960. Exhibit I details the revised calculations as well as reporting the differences between the recast and originally reported balances. The differences arose mainly due to the change in gross profit percentages from the 1997 estimates to the actual completed contracts. One job in particular (job 445), was reported as a projected loss on the original schedule of \$82,956. When the job was completed in 1998, the actual loss was \$436,063. Brown Schultz' workpapers document that there were significant problems on the job with subcontractor defaults, although it is not evident that they substantiated management's representations by vouching to subcontractor agreements or reviewing subsequent costs. The job was 38% complete and because this showed a loss it should have alerted Brown Schultz that it was necessary to do some additional inquiry and audit testing. This also relates back to my comments made in my original report regarding Brown Schultz' undue reliance placed on management's assertions, their conscious decision not to include job costs in the review of subsequent disbursements and their decision to not test subcontractor costs.

THE RESTATEMENT OF THE 1998 BROWN SCHULTZ AUDIT REPORT

The same methodology was used as the 1997 approach by utilizing the "actual" or "revised" gross profit percentage from the completed contract schedule and contracts-in-process schedule prepared as of December 31, 1999. The 1998-year resulted in overstating income by \$3,126,508.

The two year cumulative effect on net income was \$3,942,467.

I chose to use the foregoing methodology for the following reasons:

- My contention is that due to lack of audit work, specifically with the testing of subcontractors, accumulated costs to complete and subsequent job costs, Brown Schultz did not have the opportunity to correctly ascertain the profit fade on the individual contracts.
- Brown Schultz should have taken into account the material profit fade from the 1997 jobs in connection with the 1998 audit work. However, the facts are that gross profit

percentages on several jobs were in excess of any historical amounts and well above the amounts originally estimated in the contracts by the contractor (CCI).

The process used to recast the earnings and estimate the misstatement in the 1997 and 1998 audited financial statements was, in my opinion, a conservative approach. The results using the above approach yielded material exceptions. The lack of audit procedures employed by Brown Schultz did not allow them the opportunity to ascertain the misstatements regardless of the amount. Even though I took a conservative approach by using actual results, the resulting differences were significant enough such that they have to relate back to the lack of effective audit procedures employed by Brown Schultz.

PCIC RECEIVABLE

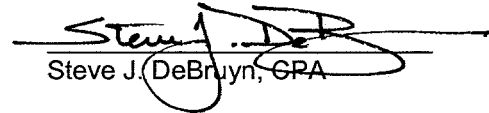
To clarify my position and opinion on the PCIC transaction recorded in the 1998 financial statements in the amount of \$1,162,460, I believe that the amount should not have been recorded and disclosed as additional contract revenue and contract overbillings. In my 1998 recast contracts-in-process schedule I did not include the total contract amount for that specific job. In my opinion, the transaction did not meet the standards to be recorded as contract revenue. In addition, a more useful disclosure would have been to report the transaction as a separate line on the balance sheet of CCI indicating that it was a guarantee by the stockholder.

PROFESSIONAL STANDARDS ISSUES

My original report noted that the audit work for Brown Schultz for the years 1997 and 1998 did not conform to applicable standards of care of a Certified Public Accountant. For example, Generally Accepted Accounting Standards (GAAS) require "Due professional care is to be exercised in the performance of the audit and the preparation of the report" (source: SAS no.1, AU section 230). Included in this section is the fact that due professional care requires the auditor to exercise professional skepticism. Based on my review of the audit workpapers for the years 1996, 1997 and 1998, Brown Schultz failed to act with sufficient professional skepticism and was not diligent in evaluating the audit evidence. Furthermore, the first standard of fieldwork requires that the work "is adequately planned and properly supervised" (source: SAS no.22, AU section 311). As noted in my earlier report, Brown Schultz's planning documentation was virtually unchanged between 1996 – 1998. Brown Schultz failed to properly address the risk involved in the audit of CCI and, therefore, did not allow the firm to modify or change the audit procedures or approach. In addition, the third standard of fieldwork requires "sufficient competent evidential matter is to be obtained ..." (source: SAS no. 31, AU section 326). As a result of Brown Schultz' limiting the testing of accumulated job costs, subcontractor costs and subsequent

disbursement of job costs, Brown Schultz denied itself the opportunity to obtain all possible evidential matter available to properly perform the audit.

Dated: September 20, 2002


Steve J. DeBruyn, CPA

SCHEDULE OF CONTRACTS IN PROGRESS - REVISED

31-Dec-97

A	B	C	D	E	F	G	H	I	J	K	L	M	N
1													
2													
3													
4													
5													
6													
7													
8													
9													
10													
11													
12													
13													
14													
15													
16													
17													
18													
19													
20													
21													
22													
23													
24													
25													
26													
27													
28													
29													
30													
31													
32													

Excess

Cost and Billings

Earnings Over

Cost and

Earnings

GP %

GP %

GP %

GP %

GP %

GP %

GP %

GP %

GP %

GP %

GP %

GP %

GP %

GP %

GP %

GP %

GP %

GP %

GP %

GP %

GP %

GP %

GP %

GP %

GP %

GP %

GP %

GP %

GP %

GP %

GP %

GP %

GP %

GP %

GP %

GP %

GP %

GP %

GP %

GP %

GP %

GP %

GP %

GP %

GP %

[illegible]

[illegible]

[illegible]

EXHIBIT V

[illegible]

COPY

IN THE UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF PENNSYLVANIA
(HARRISBURG DIVISION)

UNITED STATES FIDELITY :
AND GUARANTY COMPANY, :
PLAINTIFF : NO. 1:01-CIV-00813
 : (JUDGE KANE)
V : (MAGISTRATE JUDGE SMYSER)
 :
BRUCE J. BROWN AND BROWN, :
SCHULTZ, SHERIDAN & FRITZ, :
DEFENDANTS :

DEPOSITION OF: BRUCE J. BROWN, CPA, CVA

TAKEN BY: PLAINTIFF

BEFORE: DONNA E. RICHARDS, RPR
NOTARY PUBLIC

DATE: JANUARY 17, 2002, 9:00 A.M.

PLACE: THOMAS, THOMAS & HAFFER, LLP
305 NORTH FRONT STREET
HARRISBURG, PENNSYLVANIA

APPEARANCES:

BERNKOPF, GOODMAN & BASEMAN, LLP
BY: PETER B. McGLYNN, ESQUIRE

FOR - PLAINTIFF

SWARTZ, CAMPBELL & DETWEILER
BY: KATHLEEN CARSON, ESQUIRE

FOR - DEFENDANTS

ALSO PRESENT:
MARTIN MCCARTHY



1 mind that are -- that are awarded people. That's my
2 problem.

3 Q All right. So the answer is no?

4 A I suppose it's no, because I don't understand
5 the question.

6 Q Now, sir, you're familiar with a company called
7 CCI Construction; are you not?

8 A Yes.

9 Q How did you become familiar with CCI?

10 A We began doing their accounting work sometime
11 during the 1980s.

12 Q Were you the so-called responsible or managing
13 partner for that account?

14 A Yes.

15 Q All right. Has that always been the case?

16 A Yes.

17 Q Were you -- did you have a relationship with
18 any particular person within CCI?

19 A Well, John Ortenzio was the sole shareholder.
20 So obviously being the audit partner, I had a working
21 relationship with Mr. Ortenzio.

22 Q Were you friends with him?

23 A No.

24 Q How did you meet Mr. Ortenzio?

25 A Actually a friend of mine who had been a former

1 associate of mine at Laventhol knew him, and he -- Mr.
2 Ortenzio had spoken with Mr. Richardson, and they are
3 friends, and asked if he knew of anybody that would be
4 qualified to service his work. And Mr. Richardson
5 contacted me.

6 Q And this was approximately what year?

7 A I'm saying it's the 1980s. I can't remember
8 back that far.

9 Q And when did you -- strike that. When I use
10 the word you sometimes I should be more specific, but I'm
11 generally referring to Brown, Schultz, your firm. When
12 did Brown, Schultz first perform audit work for CCI?

13 A Are you including Laventhol? I mean, because I
14 believe -- and I don't remember exactly when. Once again,
15 I was trying to recall if we started doing that engagement
16 as a review as opposed to an audit. I just -- since it
17 goes back, I'm getting older. I can't remember anymore.

18 Q The -- as I understand it then, what you're
19 saying is that CCI first became a client of the Laventhol
20 firm?

21 A Correct.

22 Q Before you formed Brown, Schultz?

23 A Correct.

24 Q All right. Okay. And do you recall whether or
25 not either Laventhol or Brown, Schultz performed audit

1 work? And, if so, what year did that start?

2 A Both firms prepared audit work, and I don't
3 remember when it started.

4 Q Now, Brown, Schultz currently does not perform
5 any services for CCI; is that correct?

6 A Correct.

7 Q When did Brown, Schultz cease performing
8 services for CCI?

9 A The last work we did was for the tax return for
10 1999.

11 Q And that was in connection with CCI's
12 bankruptcy proceeding?

13 A Correct.

14 Q Prior to -- prior to 1999, in addition to the
15 audit work, what other services did Brown, Schultz perform
16 for CCI?

17 A I'm sorry. Say that again.

18 Q Prior to 1999 what other work other than tax
19 services did Brown, Schultz perform for CCI?

20 A All we ever did was audit and tax work. We did
21 no consulting services.

22 Q Did you provide any services for John Ortenzio
23 personally?

24 A Yes, yes.

25 Q What type of services did you provide for Mr.

1 Ortenzio?

2 A Tax return preparation.

3 Q Anything else?

4 A And we prepared a personal balance sheet for
5 him for a number of years.

6 Q Do you mean a personal financial statement?

7 A Yes.

8 Q You needed that for his bonding companies and
9 his banks, personal financial statement?

10 A My understanding was he primarily needed it for
11 his banks.

12 Q Over the years Brown, Schultz has also served
13 -- strike that. Has also provided services for a number
14 of Mr. Ortenzio's partnerships and other entities in which
15 he has an interest in, correct?

16 A Yes.

17 Q All right. I'm going to show you what's been
18 previously marked as Exhibit 7. You can identify that;
19 can you not?

20 A Yes.

21 Q Can you identify those entities on Exhibit 7
22 which at any time Brown, Schultz performed services for?

23 A Yes. Can I give a little -- there's -- it
24 would probably be easier, because you'll probably ask the
25 question, a little bit of background.

BRUCE J. BROWN, CPA, CVA
JANUARY 17, 2002

MULTI-PAGE

Page 14

1 American Asset Recovery was a Subchapter S
2 Corporation that was started and liquidated probably
3 within a year or so of each other. So that was a very
4 recent company, very small. I'm not even sure if it had
5 any operations.

6 Q Did you perform -- can you tell us with each
7 company what types of services you performed?

8 A Certainly. Tax returns. Avonland Company,
9 which was an S Corporation, we only did tax return
10 preparation work for. Its only asset was a property in
11 Colorado, and that company was liquidated in 2000.

12 Q Please continue.

13 A I'm looking down the list. CH - CSH
14 Industries is an S Corporation. We've only done work --
15 we'd only done work on that company for the last two
16 years, for the years '99 and 2000. And that company was
17 -- its operations ceased sometime during the early part of
18 2000. Mechanicsburg Land Company.

19 Q I take it you did tax work for CSH?

20 A That's what I said, tax work only.
21 Mechanicsburg Land Company was -- I don't remember much
22 about that. I think we did that company. It was an S
23 Corporation. If we did anything, it's -- it was only tax
24 work. And to be honest, I just don't remember that
25 company anymore. It was a very, very minor company.

Page 15

1 Montgomery Land Company, tax return work only.
2 It was an S Corporation, had an ownership interest in a
3 property somewhere in the south. And I believe that
4 company has since been liquidated.

5 Pennsylvania Contractors Insurance Company is a
6 Subchapter C Corporation. We did an audit of that company
7 because it was required by the insurance commissioner and
8 the Turks and Caicos. The Ortenzio Family Partnership is
9 a partnership.

10 Q Before we go on, PCIC, did you perform tax and
11 audit services for that firm?

12 A Yes. May I state this? When we do the work
13 for a company, we do both the accounting and the tax.
14 It's not separated. So either we -- if I say we do
15 accounting services, it's accounting and tax. If I say
16 tax, it's tax only.

17 Q All right.

18 A The Ortenzio Family Partnership, we do a
19 partnership tax return. Reliance Finance, Inc. is a
20 Subchapter S Corporation. I think we've been doing that
21 for three years only. There was another accountant that
22 did the work for years, and we took over it. I believe
23 this year will be our third year. We do a financial
24 statement. We did a compilation statement in the year
25 2000 and tax returns.

Page 16

1 Q Let me just go back. PCIC, what's the status
2 of PCIC as you understand it right now?

3 A PCIC is in the process of being liquidated. I
4 -- I believe that the final return on that was filed for
5 the year 2000. And the reason I'm a little unclear -- I
6 can't remember. See, the Turks and Caicos, the insurance
7 commissioner has to give approval for final liquidation,
8 and for some reason I'm fuzzy. I can't remember if that
9 actually happened in 2000, or it happened in early 2001
10 since we're -- we're already in 2002. That's why I'm a
11 little fuzzy on that.

12 Q Is Mechanicsburg Land Company still in
13 existence so far as you know?

14 A I can't recall. I don't -- I don't think so,
15 but I can't say that unequivocally.

16 Q How about Ortenzio Family Partnership?

17 A Yes, it's still in existence.

18 Q How about Reliance Finance?

19 A It's still in existence.

20 Q Okay. All right. Please continue.

21 A That's it.

22 Q That's it. So you've gone over that entire
23 list, and these are the companies that you had or did
24 perform work for in the past?

25 A Correct.

Page 17

1 Q Now, do you still perform work for John
2 Ortenzio or any of his other interests?

3 A I think I stated I still do his personal tax
4 return. I do not do a personal financial statement. And
5 I named the companies that were still in existence that we
6 still do work for.

7 Q All right. All right. So just so I understand
8 your answer, make it clear in my mind, other than
9 performing some -- some tax work and perhaps preparing a
10 personal financial statement for John Ortenzio, your firm
11 performs no other work for Mr. Ortenzio or any of his --
12 his business enterprises?

13 MS. CARSON: I object to the form.

14 MR. MCGLYNN: You may answer.

15 MS. CARSON: I also object that it's been asked
16 and answered.

17 BY MR. MCGLYNN:

18 Q You can still answer it?

19 A I did answer it, but I'll state it again. I
20 still do work on Reliance Finance. I still do work on the
21 family -- the Ortenzio Family Partnership, and I still do
22 work for John Ortenzio. And on CSH Industries I will be
23 filing a final tax return because it was inactive this
24 year. I will be filing the final tax return for 2001.

25 So, once again, John Ortenzio, Reliance Finance,

● **BRUCE J. BROWN, CPA, CVA**
JANUARY 17, 2002

Multi-Page™

Page 22

1 A Yes. If -- if -- you can't see it, but as part
 2 of the normal process when I review the planning work
 3 papers for a client, I review the permanent file contents
 4 where we update certain things. And these initials that
 5 you can't see, I can -- I can barely make out my initials,
 6 but I believe they are mine.
 7 Q And with respect to -- with respect to that
 8 last page -- and, again, the reproduction of these copies
 9 of your work papers are not as good as I had hoped, but
 10 can you identify the initials under the column prepared by
 11 starting with BOW on the top?
 12 A Well, the first is Deb Bowman for '96. '97 is
 13 Deb Bowman. And I can't make out the initials -- the
 14 first three initials.
 15 Q Would that be Ehgartner, do you think?
 16 A I can't tell.
 17 Q All right.
 18 A '98 was Bowman, and '99 was Rebinski.
 19 Q Now, what is the purpose of this particular
 20 document, Exhibit No. 1?
 21 A Well, generally accepted auditing standards
 22 require us to have an understanding of our client. And
 23 this is one of the documents that's part of the audit
 24 service that we use that we gather that information.
 25 There's several documents that we use to gather client

Page 23

1 information.
 2 Q Do you recall when this particular document --
 3 strike that. Is a new document -- a new Exhibit 1
 4 prepared every year, or is the existing document merely
 5 updated?
 6 A It's updated.
 7 Q So, for example, if we turn to page 9, which is
 8 bated stamped No. 01588, do you see that at the paragraph
 9 No. 3, investment bankers and underwriters?
 10 A Yes.
 11 Q Do you see that? There are names and telephone
 12 numbers and addresses crossed out?
 13 A Correct.
 14 Q And that's -- that's updating the original
 15 form, correct?
 16 A That's correct.
 17 Q Do you know when this original form was
 18 prepared?
 19 A It would appear from page 12 of 12 that it was
 20 originally prepared on November 29th of 1995 by Bowman.
 21 Q And if you can turn, please, to page 11 of 12,
 22 paragraph 7. That question asks you to list the primary
 23 users of the financial statements. Do you see that?
 24 A Yes.
 25 Q Do you recognize that handwriting?

Page 24

1 A I would say most of it is Deb Bowman's.
 2 Q And what is the -- why is it important to --
 3 for an auditor to know the primary users of the financial
 4 statements being audited by the accountant?
 5 A Because generally accepted auditing standards
 6 suggest that we know that.
 7 Q Is there a purpose so far as you know?
 8 A Just to have an idea of the distribution of the
 9 financial statements.
 10 Q All right. So 7 really speaks to those users
 11 that are going to receive a copy of your financial
 12 statement?
 13 MS. CARSON: Object to the form.
 14 BY MR. McGLYNN:
 15 Q You may answer.
 16 A That's our expectations as to who the users
 17 would be. We don't know factually the client distributes
 18 it to all those people.
 19 Q Now, how long have you been en -- you
 20 personally, how long have you been engaged in the audit of
 21 general contractors and subcontractors?
 22 A At least since 1981.
 23 Q And during that time period approximately how
 24 many general slash subcontractor audits have you
 25 personally been involved in?

Page 25

1 A I would have to estimate, because I didn't go
 2 back and look at my records. But I would estimate
 3 somewhere between 150 and 200.
 4 Q Okay. You are -- you are familiar, are you
 5 not, sir, with the concept of construction bonding?
 6 A Yes.
 7 Q Do you know what a construction bond -- a
 8 surety bond is?
 9 A Yes.
 10 Q What's the purpose of a construction surety
 11 bond?
 12 A Typically it's a performance bond to basically
 13 guarantee that if the contractor is unable to complete
 14 their work, that the surety steps up to the plate and is
 15 responsible for the -- the financial performance of the --
 16 of the -- of the entity being bonded.
 17 Q You have familiarity with construction bonding
 18 for the past 20 years or so?
 19 A Correct.
 20 Q And you know that the surety companies use and
 21 rely on the financial statements of their construction
 22 contractors as a basis for writing these bonds; do you
 23 not?
 24 MS. CARSON: I object to the form of the
 25 question.

Multi-Page™

BRUCE J. BROWN, CPA, CVA
JANUARY 17, 2002

Page 26

1 BY MR. McGLYNN:

2 Q You may answer.

3 A I guess I could answer it this way. Yes, I
4 know that surety bonding companies obtain the financial
5 statements. I'm not going to specifically guess exactly
6 what they do. I know that they use those to determine how
7 they give bonds.

8 I don't know what their procedures are for
9 evaluating or authenticating the information that we
10 audit. We don't have contact with them, so therefore, I
11 don't -- I don't know -- I can't say specifically,
12 firsthand knowledge, that I know what they do.

13 Q You -- in the 30 to 50 other contractors that
14 the Brown, Schultz firm has performed services for there
15 have been, on occasion, times when Brown, Schultz has
16 prepared financial statements to be sent to the bonding
17 companies, correct?

18 MS. CARSON: I object to the form of the
19 question.

20 BY MR. McGLYNN:

21 Q Let me rephrase it. You know that from -- of
22 the 30 to 50 clients that Brown, Schultz has that many of
23 them have financial statements that are prepared for the
24 purpose of getting them in the hands of the bonding
25 companies, correct?

Page 27

1 MS. CARSON: Object to the form.

2 BY MR. McGLYNN:

3 Q You may answer it.

4 A We deliver financial statements to the clients.
5 I believe, yes, that they send those financial statements
6 on to bonding companies.

7 Q Do you know the purpose that they send those
8 financial statements to the bonding companies?

9 A To obtain bonds.

10 Q And in this particular instance on Exhibit 1,
11 paragraph 7, you've -- Ms. Bowman apparently has listed a
12 number of primary users, CIT and CAT Financial. Do you
13 see that?

14 A Yes.

15 Q Well, you're not looking at the document.

16 A I saw it when you first asked the question.

17 Q I'm just testing your memory. Do you have a
18 photographic memory?

19 A No.

20 Q And CIT and CAT Financial, they were what,
21 equipment lessors or equipment lenders for CCI?

22 A Equipment lenders.

23 Q And USF & G, parenthesis, St. Paul,
24 parenthesis, do you know who or what they were?

25 A Bonding company.

Page 2

1 Q All right. Had you had any dealings with USF &
2 G or St. Paul either during your work for CCI or before?

3 A Direct work, direct contact?

4 Q Um-hum.

5 A None.

6 Q How do you know how Ms. Bowman learned of the
7 identity of USF & G in St. Paul as primary users of the
8 CCI financial statements?

9 A Inquiry of the client.

10 Q The next one I can't read. If you can help me
11 out. It's a bank, obviously?

12 A Dauphin Deposit, which is now Allfirst Bank.

13 Q All right. And the final one is?

14 A Management. And actually there's -- you say
15 the final one, the final one is actually bids. Because
16 frequently an owner-who's requested CCI to request a bid
17 may require a copy of their financial statement.

18 Q And this -- this particular exhibit was updated
19 in -- help me out here, in the years 199 -- well, first
20 prepared in 1995, correct, by Ms. Bowman, November 29?

21 A For the 1995 audit, yes.

22 Q Prepared November 29, 1995. And then it was
23 updated in 1996, correct?

24 A Updated 1996, updated 1997, updated 1998,
25 updated 1999.

Page 2

1 Q Thank you. And it appears that paragraph 7 was
2 not changed during that entire preparation slash update
3 period, correct?

4 MS. CARSON: I object to the form of that
5 question. It mischaracterizes his testimony.

6 BY MR. McGLYNN:

7 Q You may answer.

8 A Well, I don't think we can say that because we
9 -- since it's a cumulative type document, there could have
10 been changes from 1995 through 1999, and we can't tell
11 when those changes occurred on this copied document.

12 Q All right. So Brown, Schultz does not have
13 some mechanism in place to annotate on this form when
14 various things were updated?

15 A In certain cases we do. They'll -- they'll
16 color code it. I -- I can't tell because of the xerox
17 copy whether it's in pencil or could be in green, could be
18 in blue. So for that reason I -- I'm saying I can't tell.

19 Q Okay. Now, going to the 1996 audit, sir.
20 before we do that I would like to ask you one question.
21 You had indicated that you -- your firm had performed work
22 for CCI while in bankruptcy, preparation of the final tax
23 return?

24 A Correct.

25 Q And you prepared this particular affidavit in

1 me?

2 A That's what it sounds like, but I -- I put more
3 time than that in. I'm not a very good record keeper.
4 But that's what the -- that's what the billing run does
5 say.

6 Q Now, sir, in connection with this particular
7 assignment there was an engagement letter that was
8 prepared; was there not?

9 A Yes.

10 Q And Exhibit 29, is that a copy of the
11 engagement letter? I have a question before you, Mr.
12 Brown.

13 A Excuse me for a second. I'm just looking at
14 something else.

15 Q Let the record show that he's looking at his
16 time sheets.

17 A The reason -- because you were reading off the
18 April 3rd billing run, and the April 17th billing run is
19 in here also. I'm sorry. So you -- yes. Your question
20 was on the engagement letter this appears to be our
21 engagement letter for the year ended 1996.

22 Q All right. You signed that?

23 A Yes, I did.

24 Q And you quote in there a fee for the services
25 of how much?

1 budgeting purposes of approximately what the fee was going
2 to be. That was our policy with them.

3 Q Um-hum.

4 A If I had unusual circumstances that would have
5 suggested I should bill more, I would have billed more and
6 simply informed management that I was doing it and why I
7 was doing it.

8 Q Okay. Do you have any memory as to whether you
9 did, in fact, bill more for those services, sir?

10 A I don't have any memory.

11 Q Now, sir, directing your attention to Exhibit
12 28. This has been previously identified as the annual
13 budget form for 1996?

14 A Yes.

15 Q And you'll agree with me that in that
16 particular document it does indicate that there is a -- it
17 quotes the estimate or the plan fee and costs of \$21,100,
18 correct?

19 A Based upon our budget we had estimated that our
20 billing would be \$21,100.

21 Q And you'll see on the first page, sir, it has
22 the phrase planned variance, and then there's the number
23 \$3,570. Do you see that?

24 A Yes, I do.

25 Q What's that mean?

1 A We quoted an estimate of fee. It wasn't a
2 fixed fee. It was an estimate of what our fee was going
3 to be. \$21,100.

4 Q And that -- that was for both the audit and tax
5 --

6 A Correct.

7 Q -- preparation?

8 A Correct.

9 Q And you'll agree with me, however, that you
10 don't specify the tax services are in there?

11 A That is correct.

12 Q Is there a reason for that?

13 A I think it was an oversight.

14 Q And do you recall how much Brown, Schultz
15 billed CCI for the 1996 audit and tax services as -- as
16 enumerated in your engagement letter plus the tax
17 preparation that was not put in there through oversight?

18 A I didn't go back and look at the billing file,
19 so I can't say specifically.

20 Q Is it your understanding that if you provided a
21 company with an estimate, such as you did in Exhibit 29,
22 that absent some unusual circumstance that's what the
23 company was going to get billed?

24 A I stated it wasn't a fixed fee. We -- their
25 request was that we give them an estimate for their

1 A The way we establish our billing rates, because
2 all of my partners and I have come from working with
3 larger firms, we establish a billing rate which is in
4 excess of what we typically expect to realize.

5 And there's -- there's a management theory
6 behind that in that we believe that from having come from
7 where we come that people don't tend to write up work.
8 They try to bill exactly the billing rate that's been
9 suggested, or they write it down.

10 So what we do is we establish a billing rate
11 based upon a multiple of the cost rate for each employee,
12 and that's typically anywhere from a multiple of 2.8 to
13 maybe 3.5, and that's what we call the standard rate.

14 Our billing runs generate the information based
15 upon what we call the standard rate, and then we adjust
16 that accordingly based upon the nature of the services.

17 For instance, I may have a billing rate of \$175
18 an hour. There are times that the work that I do is worth
19 \$175, and I may bill 175. There are times that perhaps I
20 have to work below -- I have to do services that are below
21 those that are deserving of \$175 rate, and I may only bill
22 that at \$125, so that that constitutes a write down.

23 The average write down of all the services that
24 we perform in the course of a year is approximately 22
25 percent. So that reflects that our standard -- our

JANUARY 17, 2002

Page 38

1 planned time, the 280 hours, had a -- based upon the
2 standard rates had an estimate of simply multiplying the
3 hours times the standard rates of \$24,670.

4 We planned to bill this based upon previous
5 experience at approximately 21,100, meaning that we were
6 writing down from our standard rates at 14 percent, which
7 was -- is roughly two thirds of what our normal write down
8 is for the firm as a whole.

9 Q Why wouldn't you just -- why wouldn't you just
10 bill out your time straight to CCI? If it was 24,000, you
11 bill them 24,000?

12 A Well, like I say, what we do is we create these
13 rates. It's a management theory. We create the rates
14 higher than what we really expect to realize.

15 You have to understand billing philosophies and
16 the people that are in your organization. And I applaud
17 your firm if you're able to get your standard rate all the
18 time. We find that we don't.

19 We have some work that we can get standard
20 rates. We have some work that we can get above standard
21 rates. But typically, because of the competition in the
22 marketplace, our standard write down is approximately 22
23 percent.

24 Q So in -- in the case of Exhibit 28 there was a
25 projected write down of 14 percent?

Page 39

1 A Which was --

2 Q Better than your --

3 A Much better than --

4 Q The standard?

5 A Than the normal for the firm. You realize, of
6 course, that like the national firms, they're billing
7 rates for -- I would probably bill out at \$600 an hour.
8 In -- in this marketplace -- in this marketplace you can't
9 get \$600 an hour. That's a standard that's set.

10 We do the same thing. We go by the same
11 philosophy. We use a standard rate. Because I know my
12 partners. My partners will write down. They will not
13 choose to write up. So I set the bar a little higher in
14 the hope that they don't take it down too low.

15 Q Now, in this particular case the members of the
16 team for 1996 were Ehgartner, you, Bowman, and, I believe,
17 Ricchiuti?

18 A Correct.

19 Q And Ehgartner was the so-called manager on this
20 particular assignment?

21 A Correct. Sue was a person who had started with
22 me in 1985. So by 1996 she had 11 years of experience.
23 Our managers are working managers. They work in the
24 field. So by nine years I was already a partner. She had
25 11 years experience. So she was -- she was the major

Page 40

1 person responsible for the field work.

2 Q Now, Ms. Bowman was also involved in this
3 particular audit as well; was she not?

4 A Correct. She started with the firm in 1986,
5 and so she had ten years experience at that point.

6 Q Ms. Rebinski also worked on this particular
7 audit as well, correct?

8 A No, she did not. Well --

9 Q She performed tax work on this particular
10 assignment?

11 A That is correct.

12 Q She also was, in the past, a so-called
13 supervisor; was she not?

14 A That's correct.

15 Q What was Bowman's official title at Brown,
16 Schultz?

17 A She was a supervisor.

18 Q How about Ms. Ehgartner?

19 A Manager.

20 Q And the manager is above a supervisor?

21 A Correct.

22 Q You heard testimony that in all three years Ms.
23 Rebinski did not serve as a supervisor on any of the three
24 -- three audits for CCI. Did you hear that testimony?

25 MS. CARSON: You can answer.

Page 41

1 BY MR. McGLYNN:

2 Q Yes or no? Well, I mean, did you hear it, or
3 didn't you hear it? Let's start with that.

4 A Well, the difficulty that you're getting into
5 is it's a play on words. She was a supervisor, which
6 identifies the -- the level of experience that she had.
7 She was not responsible on this particular engagement to
8 run the day to day operation of the engagement.

9 Therein lies the difference. It's that she was
10 a supervisor, was qualified to supervise, but because of
11 having two other people with over ten years experience on
12 the job, we didn't need for her to supervise on this job.

13 Q How much experience in 1986 -- excuse me, 1996
14 did Ms. Rebinski have?

15 A She's got -- I -- I didn't look at her records.
16 I think that she started around 1984 or 1985 also. So she
17 had about 12 years of experience.

18 Q Now, sir, what, if any, role did you have in
19 formulating the audit plan for this particular 1996 CCI
20 audit?

21 A Well, the way -- the way the process works is
22 prior to the engagement the person who's performing the
23 audit planning and I will meet briefly to discuss the
24 staffing, discuss generally what some of our expectations
25 are.

Page 38 - Page 41

HUGHES, ALBRIGHT, FOLTZ & NATALE
717-540-0220/717-393-5101

BRUCE J. BROWN, CPA, CVA
JANUARY 17, 2002

Multi-Page™

Page 78

1 Q Now, you're familiar with, as we covered it
 2 earlier this morning, PCIC?
 3 A Correct.
 4 Q And PCIC stands for what, sir?
 5 A Pennsylvania Contractors Insurance Corporation.
 6 Q And this was a company that was owned or
 7 controlled by Mr. John Ortenzio?
 8 A Correct.
 9 Q Was it set up as of 1996 to your knowledge?
 10 A Yes.
 11 Q And PCIC was an offshore company?
 12 A Correct.
 13 Q Turks and Caicos company, as I understand it,
 14 correct?
 15 A Correct.
 16 Q And it was set up by Mr. Ortenzio to serve as a
 17 captive insurance company for CCI?
 18 A Correct.
 19 Q And what was the purpose of that particular
 20 company as you understand it?
 21 A My understanding -- and we did not make the
 22 recommendation that this be, so it wasn't our idea.
 23 Q It wasn't your idea to do what?
 24 A It was not our idea to form PCIC. It was not a
 25 tax recommendation.

Page 79

1 Q All right.
 2 A PCIC was basically a mechanism -- it was a tax
 3 consideration. There was a recommendation by consultants
 4 that Mr. Ortenzio had that recommended that by creating a
 5 qualified offshore insurance company he could defer income
 6 taxes by -- by paying premiums to this company and then
 7 utilizing those proceeds to fund remedial warranty work as
 8 it became necessary based upon the premiums that were paid
 9 in.
 10 And basically because of the continued
 11 profitability of CCI, PCIC was formed as a mechanism to
 12 defer income taxes.
 13 Q PCIC was solely funded by the premiums paid by
 14 CCI?
 15 A Not solely, because there was some other
 16 insurance that was sold by PCIC. But the majority of the
 17 funding came from CCI.
 18 Q To your knowledge was PCIC set up and running,
 19 if you will, during the 1996 audit year? And, again,
 20 you're referring to Exhibit 17?
 21 A I'm referring to Exhibit 17 because I'm going
 22 to look at the related party transactions.
 23 Q Paragraph 7?
 24 A Yes. And it does not appear in 1996 that any
 25 premiums were paid to PCIC in that particular year.

Page 80

1 Although I know in 1997 that there were. So, therefore, I
 2 know it was in existence in 1996.
 3 MR. McGLYNN: All right. Can we take a short
 4 break, two minutes?
 5 MS. CARSON: Sure.
 6 (Recess was taken from 11:13 a.m. to 11:24
 7 a.m.)
 8 BY MR. McGLYNN:
 9 Q Brown, Schultz performed the audit work for
 10 PCIC, correct?
 11 A Correct.
 12 Q Now, in terms of job cost analysis there was
 13 also a audit program for work in process for 1996,
 14 correct?
 15 A Correct.
 16 Q Is this a copy of it, sir?
 17 A I'm sorry. You said this was the audit program
 18 step. This was not the audit program step. This was one
 19 of the work papers for the work in process testing.
 20 Q All right. This is the -- and I'm sorry. I
 21 misspoke. This is the work paper that describes what was
 22 done to analyze the work in progress, correct -- work in
 23 process, correct?
 24 A No. Unfortunately that's not totally correct.
 25 This is the Tickmark legend which supports the actual work

Page 81

1 papers. There actually could be some -- without looking
 2 at them, there might be more documentation on the various
 3 pages.
 4 Q Could you point out -- since I'm obviously
 5 having some difficulty locating it myself, point out what
 6 the -- where the work paper is that relates to work in
 7 process? While he's looking I will have this marked as
 8 the next exhibit though.
 9 (Completed contracts sheet was produced and
 10 marked as Deposition Exhibit No. 33.)
 11 BY MR. McGLYNN:
 12 Q Perhaps you can look at Exhibit 21. Would that
 13 have it on there on page bate stamp 00940?
 14 A I know it's the R6 work papers. And the
 15 problem is, as we discussed, they don't all copy real
 16 well. And I'm trying to see which are the R6 work papers.
 17 Q And, again, R6 is?
 18 A It's an internal reference to work papers.
 19 Q And that's -- that particular description, R6,
 20 is shown on Exhibit 33, correct?
 21 A I'm sorry. I wasn't listening.
 22 Q R6 is found on Exhibit 33?
 23 A That's one in the series, yes. Yes, here it
 24 is. Okay. The work papers with respect to work in
 25 process starts at bate stamp 00986 and appears to continue

Multi-Page™

BRUCE J. BROWN, CPA,
JANUARY 17,

Page 154

1 any cost or any claim that arose as a result of a -- of a
2 defaulting subcontractor other than replacement of the
3 masonry subcontractor, Johnson Masonry, Inc.?

4 A And replacement of the sheet issues and the
5 fault of the sheet metal fabricator. If you look at 00305
6 and 00303, the net impact of the budgets were 448 and
7 452,000, which is 900,000 out of a claim of 1,162,000.

8 Q Who prepared this document on 00305?

9 A The same people that prepared the claim. This
10 is all CCI's work.

11 Q All right. But you'll agree with me the claim
12 submission appearing on CCI's letterhead only appears at
13 00291 through 00299?

14 MS. CARSON: I object to the form.

15 BY MR. McGLYNN:

16 Q You may answer. In fact, it's not even the
17 same typeface?

18 A It's on the guaranty. It's all part -- it's
19 part and parcel of all the documentation provided by PCI
20 -- CCI to our audit people.

21 Q Can you point to any portion of these work
22 papers that details the analysis that Brown, Schultz made
23 to support its conclusion that this 1,162,000 was fully
24 insured under the policy appearing at 00306?

25 A There are comments on 00291 and comments on

Page 155

1 00305, which is the audit documentation with respect to
2 our assessment. And it is -- it is as documented.

3 Q Now, if, in fact, it turns out -- strike that.
4 Was there any determination made as part of this audit
5 whether or not PCIC had the ability to satisfy in full a
6 claim of 1,162,000?

7 A Yes.

8 Q Is that reflected in these work papers?

9 A It's not needed to be reflected since we had
10 the audit files. It was all cash and securities. So it's
11 very easy to claim, and we didn't document it.

12 Q But it's your testimony today that as of 12/31
13 -- actually as of February, 1999, which was when you
14 completed your field work for this particular audit, PCIC
15 had approximately \$1.2 million in cash that they could
16 have used to satisfy this claim?

17 A Yes.

18 Q PCIC now is undergoing liquidation?

19 A Yes.

20 Q And when did that formal liquidation process
21 start?

22 A I'm thinking it was the -- honestly, I can't
23 remember. I -- I can't remember if it was the fall of
24 2000. It was sometime -- best of my recollection, it's
25 between June of 2000 and June of 2001.

1 Q Roughly about a year and a half after this
2 audit had been completed?

3 A Correct.

4 Q Do you know whether or not PCIC ever paid the
5 1,162,000 claim?

6 A I believe it was paid.

7 Q Where would that be reflected? When was the
8 last time -- strike that. I'll withdraw that question.

9 What was the last year that Brown, Schultz audited PCIC?

10 A 1998.

11 Q All right. So there was no audit for 1999?

12 A Correct.

13 Q And if this claim was paid, it would not have
14 been paid until after -- clearly after February, 1999,
15 correct?

16 A That's correct. But we did an audit of PCIC
17 for 1999, and we would have done a tax return for 2000.

18 Q I'm sorry. I thought you just said the last
19 audit you did for PCIC was 1998?

20 A I didn't say that. I said CCI. If I said
21 that, I misspoke.

22 Q All right. So you did an audit for PCIC in
23 1999?

24 A I believe that's correct. Because the Turks --
25 the insurance commissioner of the Turks and Caicos s

1 required the audit.

2 Q And you have a memory of this 1,162,000 being
3 paid by PCIC?

4 A I -- yes. Although I -- I can't say I remember
5 when or -- I do believe it was paid.

6 Q How much money did they -- did PCIC have on
7 hand that was unrestricted in terms -- it was not reserved
8 against other losses as of February, 1999?

9 A I don't remember. All I do recall though is
10 because the -- they had to communicate with the insurance
11 commissioner, there was a required minimum amount
12 a reserve that was required under -- under the insurance
13 laws. And that was the only amount still remaining after
14 all claims had been paid out.

15 And they were making application to the
16 insurance commissioner documenting that all insurance
17 claims had been paid out and to waive any kind of waiver
18 period to run out claims because all -- all contracts --
19 all claims had been settled by the end of -- of 1999 or
20 2000. 2000, actually.

21 Q If -- if you had determined that in whole or in
22 part the \$1,162,000 claim was uninsured by the PCIC
23 policy, how would that have impacted on the -- on the
24 Brown, Schultz audit report?

25 MS. CARSON: I object to the form.

Multi-Page™

1

UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT
OF PENNSYLVANIA
HARRISBURG DIVISION

* * * * *

UNITED STATES *
FIDELITY AND * Civil Action
GUARANTY COMPANY, * No. 1:01-CV00813
Plaintiff *
vs. *
BRUCE J. BROWN *
and BROWN SCHULTZ *
SHERIDAN & FRITZ, *
Defendants *

* * * * *

DEPOSITION OF
SUSANNE EHGARTNER

JUNE 11, 2002

Any reproduction of this transcript
is prohibited without authorization
by the certifying agency

Multi-Page™

Page 78

1 parenthetical, Saint Paul?
 2 A. Yes.
 3 Q. Can you identify that
 4 handwriting?
 5 A. No.
 6 Q. Is that Corrine Rabinsky's
 7 handwriting?
 8 A. I don't know.
 9 Q. To your knowledge was Mrs.
 10 Rabinsky working on the 1996 audit
 11 along with you and Ms. Bowman?
 12 A. Yes, I believe she was.
 13 Q. Do you know her
 14 handwriting? Can you recognize her
 15 handwriting?
 16 A. I don't know if I would.
 17 No, I'm not sure I would recognize
 18 it.
 19 Q. And do you know what the
 20 question seven is designed to
 21 elicit, what information question
 22 seven is designed to elicit?
 23 A. Who we felt the primary
 24 users of the financial statements
 25 would be.

Page 79

1 Q. Is that important in
 2 connection with the planning of an
 3 audit ---
 4 A. Yes.
 5 Q. --- to know who the
 6 primary users are?
 7 A. Yes.
 8 Q. Why?
 9 A. It helps assess who is
 10 going to be using the financial
 11 statements and what they may be
 12 looking for. It may help in
 13 determining what kind of risk there
 14 is.
 15 Q. What do you mean by what
 16 kind of risk there is?
 17 A. We look at overall
 18 inherent risk in an audit.
 19 Q. Can you be more specific
 20 in what you mean by more inherent
 21 risk?
 22 A. More inherent risk?
 23 ATTORNEY CARSON:
 24 Object to the form.
 25 That's not what she said.

Page 80

1 It mischaracterizes her
 2 testimony.
 3 ATTORNEY MCGLYNN:
 4 Well, no, I think
 5 maybe the witness has to
 6 speak up a little bit.
 7 I'm just having a little
 8 ---.
 9 ATTORNEY CARSON:
 10 One second. Peter,
 11 if you can't hear the
 12 witness, please just let
 13 her know so that she can
 14 speak up.
 15 BY ATTORNEY MCGLYNN:
 16 Q. Please speak up. You said
 17 something about inherent risk?
 18 A. Overall inherent risk.
 19 Q. Overall inherent risk.
 20 And would you be more specific on
 21 what you mean by overall inherent
 22 risk?
 23 ATTORNEY CARSON:
 24 Object to the form.
 25 A. Well, if I recall, there

Page 81

1 was a form that we would go through
 2 and look at overall inherent risk,
 3 whether it was a high risk or a
 4 normal risk client.
 5 BY ATTORNEY MCGLYNN:
 6 Q. And did you understand at
 7 the time that you were involved in
 8 the 1996 audit that among others,
 9 USF&G would be a primary user of the
 10 financial statement?
 11 A. Yes.
 12 Q. Did you undertake to learn
 13 anything further as to what use
 14 USF&G would have with the financial
 15 statement?
 16 ATTORNEY CARSON:
 17 Object to the form.
 18 BY ATTORNEY MCGLYNN:
 19 Q. You may answer.
 20 A. I'm not sure I understand
 21 the question.
 22 Q. You knew that USF&G was
 23 going to be one of the primary users
 24 of the financial statement?
 25 A. Yes.

Multi-Page™

Page 82

Page

1 Q. For the 1996 audit;
 2 correct?
 3 A. Yes.
 4 Q. Did you know for what
 5 purpose USF&G would use the
 6 financial statement?
 7 A. Well, responding companies
 8 require audited financial
 9 statements, I would assume to assess
 10 their own --- whether they wanted to
 11 continue to provide bond into a
 12 company or not.
 13 Q. Did you know that that was
 14 the case with respect to USF&G in
 15 connection with the 1996 audit?
 16 ATTORNEY CARSON:
 17 Object to the form.
 18 BY ATTORNEY MCGLYNN:
 19 Q. You may answer.
 20 A. I would assume I knew
 21 that, yes.
 22 Q. And was this something
 23 that you learned for the first time
 24 in connection with the 1996 audit of
 25 CCI?

1 specific bonds. I don't ---.
 2 BY ATTORNEY MCGLYNN:
 3 Q. You indicated that one of
 4 the things that question seven was
 5 designed to answer is the types of
 6 companies or individuals that would
 7 be receiving and using in some way
 8 the audited financial statements
 9 prepared by Brown Schultz; correct?
 10 A. Yes.
 11 Q. And that was information
 12 that you as an auditor would employ
 13 in the overall planning of the
 14 audit; correct?
 15 A. Yes.
 16 Q. And the reason why you
 17 would employ that would be to assess
 18 the overall inherent risk that would
 19 be attendant with the financial
 20 statements prepared by CCI's
 21 management; correct?
 22 A. Can you repeat the
 23 question?
 24 Q. You would use the
 25 information in question seven to

Page 83

Page

1 ATTORNEY CARSON:
 2 Object to the form.
 3 A. Yes.
 4 BY ATTORNEY MCGLYNN:
 5 Q. You knew that USF&G was a
 6 bonding company; correct?
 7 A. Yes.
 8 Q. And did you know that
 9 USF&G at that time issued bonds ---
 10 considered issuing bonds to CCI?
 11 A. Not to my recollection.
 12 Q. Did you take any steps to
 13 check out whether or not CC ---
 14 whether or not USF&G had issued or
 15 was considering issuing bonds to
 16 CCI, in connection with the 1996
 17 audit?
 18 ATTORNEY CARSON:
 19 Objection to the
 20 form.
 21 A. To my recollection, I knew
 22 they were the bonding company for
 23 CCI. I don't recall whether --- I
 24 guess I'm not sure I understand the
 25 question, whether they provided

1 assess the level of scrutiny that
 2 you would put into the audit of CCI;
 3 correct?
 4 ATTORNEY CARSON:
 5 Object to the form.
 6 BY ATTORNEY MCGLYNN:
 7 Q. You may answer.
 8 A. Yes, that among other
 9 things.
 10 Q. If you knew, for example,
 11 that the Dauphin Deposit Bank was
 12 relying on audited financial
 13 statements in connection with the
 14 extension or the continuation of a
 15 line of credit, how would that
 16 impact on the planning of the audit
 17 for CCI?
 18 A. Well, you know the bank is
 19 an user, it might be more than
 20 that. I mean, perhaps in the line
 21 of credit agreement there was
 22 certain performance rate --- you
 23 know, issues or ---.
 24 Q. Financial evidence?
 25 A. Yes, that might have to be

Multi-Page™

Page 154

Page 15

1 A. Yes.
 2 Q. And so the answer to
 3 question four was that there was a
 4 risk of overstatement by CCI so that
 5 the financial condition of the
 6 company would be more favorably to
 7 its bank and its bonding company;
 8 correct?

9 ATTORNEY CARSON:
 10 Object to the form.

11 BY ATTORNEY MCGLYNN:

12 Q. You may answer.

13 A. I think we're identifying
 14 that the fact that there are
 15 creditors, that because of that you
 16 would tend to have an overstatement
 17 risk, if that answers your
 18 question. I'm sorry.

19 Q. Maybe I'm just not asking
 20 the question correctly. Let's start
 21 again. It lists the bank and the
 22 bonding company as significant
 23 creditors; correct, according to
 24 this question four, the answer to
 25 this question four?

1 overstatement, what would the
 2 auditor normally do having been
 3 armed with that information?

4 A. Well, you intended to
 5 design your tests to test for
 6 overstatement of assets and revenue
 7 and understatement of liabilities
 8 and expenses.

9 Q. And in connection with a
 10 construction company, what would you
 11 do to determine whether things had
 12 been over or understated, as you've
 13 just testified?

14 A. I would design tests to
 15 --- I mean, depending on the cycle,
 16 for example, in accounts payable,
 17 you would want to do a search
 18 looking for things that weren't
 19 recorded that should have been as
 20 opposed to if it was understatement,
 21 you'd want to look at what was there
 22 that possibly shouldn't be.

23 Q. Now, question six, same
 24 page, BSSF1061, take a moment to
 25 read that.

Page 155

Page 15

1 A. Yes.
 2 Q. All right. And as
 3 significant creditors, did you have
 4 any knowledge that they would be
 5 relying on anything contained in the
 6 audited financial statement?

7 A. Yes.

8 Q. And they would be relying
 9 on the audited financial statement
 10 in connection with either the
 11 extension of bank credit or the
 12 extension of a surety credit.

13 ATTORNEY CARSON:
 14 Object to the form.

15 BY ATTORNEY MCGLYNN:

16 Q. You may answer.

17 A. Yes.

18 Q. And because of that there
 19 was a risk that management would
 20 overstate its financial condition in
 21 order to continue to get bank and
 22 surety credit?

23 A. Yes.

24 Q. And when such a condition
 25 is noted, that there is a risk of

1 A. Okay.
 2 Q. Can you identify the
 3 handwriting opposite question six,
 4 is that Ms. Bowman's or anyone
 5 elses?

6 A. It looks like Deb
 7 Bowman's.

8 Q. And what is this question
 9 designed to elicit?

10 A. Whether we think the
 11 financial statements are going to
 12 come under unusual or different
 13 scrutiny than you would typically
 14 expect.

15 Q. How does the information
 16 that's being elicited in question
 17 six differ from that which is being
 18 elicited in question four?

19 A. Well, to me, question four
 20 is asking whether there are any
 21 significant creditors and question
 22 six is asking what kind of scrutiny
 23 will those creditors give the
 24 financial statements.

25 Q. And Ms. Bowman answers no

COPY 7

IN THE UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF PENNSYLVANIA

UNITED STATES FIDELITY AND
GUARANTY COMPANY,

PLAINTIFF

V

BRUCE J. BROWN AND BROWN SCHULTZ: JUDGE KANE
SHERIDAN & FRITZ,

DEFENDANTS

:
:
: CIVIL ACTION
: NO. 1:01-CV-00813
:
:
:

DEPOSITION OF: DEBORAH BOWMAN

TAKEN BY: PLAINTIFF

BEFORE: TAMMY J. BAKER, REPORTER
NOTARY PUBLIC

DATE: MAY 21, 2002, 10:00 A.M.

PLACE: THOMAS, THOMAS & HAFFER
305 NORTH FRONT STREET
HARRISBURG, PENNSYLVANIA

APPEARANCES:

BERNKOPF, GOODMAN & BASEMAN, LLP
BY: PETER B. McGLYNN, ESQUIRE

FOR - PLAINTIFF

SWARTZ, CAMPBELL & DETWILER
BY: KATHLEEN M. CARSON, ESQUIRE

FOR - DEFENDANTS

HAEN
Reporting Service, Inc.
Hughes
Albright
Foltz
Natale

DEBORAH BOWMAN
MAY 21, 2002

Multi-Page™

<p style="text-align: right;">Page 30</p> <p>1 Q Do you know whether or not USF&G ever actually 2 received copies of audited financial statements of CCI 3 prepared by Brown Schultz? 4 A I do not. 5 Q But somebody told you or you had perceived 6 knowledge that USF&G would be receiving financial 7 statements, such financial statements? 8 MS. CARSON: Object to the form. 9 THE WITNESS: Perceived knowledge, yes. I assumed 10 the client -- Brown Schultz was not responsible for 11 providing that to them, the client would have been. 12 BY MR. McGLYNN: 13 Q And you learned that the client was going to be 14 providing these financial statements to USF&G from somewhere 15 or somebody? 16 MS. CARSON: Object to the form. 17 BY MR. McGLYNN: 18 Q You may answer. 19 A Yes. 20 Q And you cannot recall who that person or who 21 those persons were? 22 A I just knew the bonding company was a user and 23 the client would be submitting them financials. I don't 24 know from where or who or... 25 Q Did you, during the period 1991 to 1999, did you</p>	<p style="text-align: right;">Page 32</p> <p>1 Q Do you know the reason why CCI's bank or banks 2 were users of the audited financial statements? 3 MS. CARSON: Object to the form. 4 THE WITNESS: Again, just their relationship with 5 CCI, whether or not they had lines of credit or loans or 6 something out there. And they might have. I just don't 7 recall at this point what their debt situation was during 8 that time period. 9 BY MR. McGLYNN: 10 Q Were the banks using -- to your knowledge were 11 the banks using these financial statements to determine 12 whether to extend further credit to CCI? 13 A I don't have knowledge of that. 14 Q You didn't -- as part of your work as an auditor 15 of CCI, you reviewed various contracts and loan documents 16 each year, did you not? 17 MS. CARSON: Object to the form. 18 BY MR. McGLYNN: 19 Q You may answer. 20 A Yes, we might have looked at whatever agreements 21 were out there. If there was a line of credit, we would 22 have confirmed any debt. 23 Q And you, from your experience reviewing these 24 various documents, you know that those documents contain 25 covenants or requirements that audited financial statements</p>
<p style="text-align: right;">Page 31</p> <p>1 take any steps to understand generally the relationship 2 between a bonding company and a construction contractor? 3 A Just what I have already told you. 4 Q Did you take any steps to understand the reason 5 or the circumstances under which a bonding company like 6 USF&G would be receiving or would be a user of the audited 7 financial statements of CCI? 8 MS. CARSON: Object to the form. 9 THE WITNESS: They would be a user just as the 10 bank would be a user or somebody interested in -- who might 11 have loaned them money or whatever. I mean they were a user 12 of the financials. What they did with the financial 13 statements, I don't know. 14 BY MR. McGLYNN: 15 Q Did CCI have any banks that were users of the 16 audited financial statements of CCI? 17 A I know they had -- I'm not really sure of their 18 total debt situation at that point. I know they had, you 19 know, operating accounts with banks and that kind of thing. 20 As far as lines of credit, debt, I can't speak to that. I 21 don't recall. 22 Q But you knew that a bank or banks were users of 23 the CCI audited financial statements? 24 A In general, yeah, they would have had a 25 relationship with a financial institution.</p>	<p style="text-align: right;">Page 33</p> <p>1 be provided to the bank, don't you? 2 MS. CARSON: Object to the form. 3 BY MR. McGLYNN: 4 Q You may answer. 5 A They might have. 6 Q And you don't know the reason the bank required 7 or was a user of these financial statements? 8 MS. CARSON: Object to the form. 9 THE WITNESS: Again, I don't know if they were -- 10 you know, if they have a line of credit out there I'm sure 11 they would be very interested in making sure that CCI was 12 falling within the ratios that they put out in their debt 13 covenants. 14 BY MR. McGLYNN: 15 Q To see how the company's doing financially? 16 A Sure. 17 Q And with respect to USF&G, USF&G was issuing 18 construction surety bonds to CCI, correct? 19 MS. CARSON: Object to the form. 20 BY MR. McGLYNN: 21 Q You may answer. 22 A As I recall. 23 Q And that was, to your knowledge, every year from 24 1991 at least until your departure in 1999? 25 MS. CARSON: Object to the form.</p>

DEBORAH BOWMAN
MAY 21, 2002

Multi-Page™

Page 62

1 Exhibit No. 5.)
 2 BY MR. McGLYNN:
 3 Q Now, if you would please turn to BS 01756. And
 4 here's a separate -- what I believe and hope is a separate
 5 copy of that particular page.
 6 A It looks like the same document.
 7 Q Can you identify this document?
 8 MS. CARSON: Do you want her to read you the
 9 title?
 10 MR. McGLYNN: Excuse me?
 11 MS. CARSON: Would you like her to read you the
 12 title? Is that what you're asking her to do.
 13 BY MR. McGLYNN:
 14 Q We are all able to read. It says master surety
 15 agreement. Can you identify this document? Have you seen
 16 it before?
 17 A Again, I don't recall.
 18 Q It refers to a master surety agreement between
 19 CCI Construction Company and United States Fidelity and
 20 Guaranty Company. Do you see that?
 21 A Yes.
 22 Q And do you have any personal knowledge of a
 23 master surety agreement between USF&G and CCI?
 24 A I don't have any recall of the surety agreement
 25 other than knowing, you know, there was a bonding company

Page 63

1 involved.
 2 Q All right. You will agree with me, though, that
 3 this is at least part of what you generally identified as
 4 part of the permanent file of CCI at Brown Schultz, correct?
 5 A Yes.
 6 MR. McGLYNN: Why don't we have this marked as
 7 Bowman 6.
 8 (Master Surety Agreement produced and marked
 9 Bowman Exhibit No. 6.)
 10 BY MR. McGLYNN:
 11 Q If -- could you please turn to BS 01853. And if
 12 you would, please, just compare that page with the page I've
 13 just handed to you, Ms. Bowman.
 14 A It looks like the same document.
 15 Q All right. Do you have any knowledge of what
 16 this particular document is, BS 01853?
 17 A It appears to be testing -- a work paper to
 18 determine if the levels were -- if everything fell within
 19 the levels.
 20 Q The -- would you agree that the left hand portion
 21 of -- let's have this marked. Why don't we have this marked
 22 as Bowman 7 so we have an accurate record.
 23 (Work paper and Consent of Shareholder produced
 24 and marked Bowman Exhibit No. 7.)
 25 BY MR. McGLYNN:

Page 64

1 Q Would it be fair to say that the left hand
 2 portion of Bowman 7 is kind of a chopped up version or a
 3 reduced version of Bowman No. 5, this document?
 4 A Yes.
 5 Q And the right hand portion appears to be a work
 6 paper?
 7 A Yes.
 8 Q And this is a Brown Schultz work paper?
 9 A If it was in the Brown Schultz permanent file,
 10 yes.
 11 Q And this is a -- this is a work paper that was
 12 prepared by Corrine Rebinski?
 13 A It looks like her -- yes, her sign off.
 14 Q And do you know anything -- did you have any
 15 involvement with the preparation of this work paper?
 16 A No, I did not.
 17 Q Do you know what the work paper -- strike that.
 18 Do you know the circumstances under which this
 19 work paper was prepared?
 20 A Again, to make sure we were within the levels as
 21 stated.
 22 Q All right. So -- and you don't have any personal
 23 knowledge of the preparation of this work paper?
 24 A No, I don't.
 25 Q This was done it says year ended 12/31/1997?

Page 65

1 A Yes, it does.
 2 Q So this would have been prepared in connection
 3 with the audit report for the fiscal year ended December
 4 1997?
 5 A Yes.
 6 Q You were involved in that audit, were you not?
 7 A Yes.
 8 Q You were a supervisor at that time?
 9 A Yes.
 10 Q Do you recall -- and Ms. Rebinski reported to
 11 you, did she not?
 12 A We were both supervisors.
 13 Q And did you report to anybody in connection with
 14 the 1997 audit report?
 15 A I don't -- again, as I stated earlier, I know
 16 Suzanne Eghartner would have been the manager on the job
 17 that year, but again I don't -- I'm not certain on that.
 18 Q If you would please turn to BS 02593. And if you
 19 could identify this as being a true and accurate copy of
 20 that particular page that you're looking at in Bowman 2?
 21 A Yes, it appears to be.
 22 MR. McGLYNN: May we have this marked as the next
 23 exhibit, Bowman 8.
 24 (Performance Bond produced and marked Bowman
 25 Exhibit No. 8.)

DEBORAH BOWMAN
MAY 21, 2002

Multi-Page™

Page 78

1 S user and that's an abbreviation for financial statement?
 2 A Yes.
 3 Q And over towards the right you say bonding
 4 company is also F slash S user?
 5 A Uh-huh.
 6 Q And the bonding company to your knowledge was
 7 USF&G at this time?
 8 A Again, I know that by looking at documents here.
 9 Q All right. But this is your handwriting?
 10 A Yes.
 11 Q And this is handwriting under a paragraph that
 12 deals with significant creditors, correct?
 13 A Uh-huh.
 14 Q Does your memory -- does this refresh your memory
 15 at all as to whether or not the bonding company was a
 16 creditor or became a significant creditor of CCI?
 17 A They were a user of the financial statements.
 18 Q But you put the bonding company as a user of the
 19 financial statements in reference to a question asking who
 20 the significant creditors were. Do you see that?
 21 MS. CARSON: Is there a question?
 22 BY MR. McGLYNN:
 23 Q That's a question.
 24 A Yes, I did.
 25 Q Did anybody tell you to put this in?

Page 79

1 A Not that I recall.
 2 Q You did it yourself?
 3 A I don't recall. That is my writing, so...
 4 Q Over on the far right it says Part B, code, do
 5 you see a zero.
 6 A Right.
 7 Q What does the zero mean?
 8 A I believe that means overstatement.
 9 Q In other words, overstatement in that management
 10 might be trying to enhance the financial statement because
 11 banks and bonding companies were going to be users of the
 12 financial statement?
 13 A That would be the risk involved.
 14 Q And so, in other words, this particular form at
 15 least tries to identify --
 16 A Possible.
 17 Q -- possible risks in terms of the information
 18 that you're getting from management that you're going to
 19 audit, correct?
 20 A Right.
 21 Q And this would indicate that there would be or
 22 there should be a -- at least consideration of a higher
 23 level of scrutiny because management might want to try to
 24 askew the financial statements to look more favorably to
 25 banks and bonding companies?

Page 80

1 MS. CARSON: Object to the form.
 2 BY MR. McGLYNN:
 3 Q You may answer.
 4 A Yes.
 5 Q Paragraph 5, this paragraph asks about
 6 indications of significant or unusual related party
 7 transactions?
 8 A Uh-huh, yes.
 9 Q Can you read that? That's your handwriting
 10 there, Ms. Bowman?
 11 A Yes.
 12 Q All right. Can you read that for us?
 13 A Just my handwriting or the whole --
 14 Q Yes.
 15 A Transactions with related parties do occur;
 16 however, they are not considered significant or unusual.
 17 Q Do you know what kind of related party
 18 transactions there were back in the year 1996?
 19 A I don't recall specifics.
 20 Q Paragraph 6, this paragraph or question deals
 21 with what type -- strike that. Deals with what?
 22 A If the financial statements receive unusual
 23 scrutiny by their users.
 24 Q And then you have certain handwriting under there
 25 as well?

Page 81

1 A Yes.
 2 Q And could you read that for us?
 3 A My indication is the user as being management,
 4 the bank. I believe that says bonding company and then I
 5 have a slash where I say no unusual scrutiny.
 6 Q Okay. Six deals with -- well, six deals with
 7 users that might be scrutinizing the financial statements,
 8 correct?
 9 A Users that are looking at the financial
 10 statements, yes.
 11 Q And you said -- is that no unusual scrutiny? Is
 12 that your handwriting?
 13 A That's right.
 14 Q What do you mean by no unusual scrutiny?
 15 A They wouldn't be looking at them in any different
 16 way than a bank would look at another client.
 17 Q Can you differentiate for me or distinguish the
 18 difference between usual and unusual scrutiny?
 19 A No.
 20 Q You don't have a memory as to why you indicated
 21 no unusual scrutiny underneath Paragraph 6?
 22 A No.
 23 Q Would you please turn to Paragraph 15, second
 24 page.
 25 A Yes.

Multi-Page™

DEBORAH BOWMAN
MAY 21, 2000

Page 122

1 that this \$430,000 approximately of indirects did not tie
2 into any particular job?
3 A Well, if I can find --
4 Q I think it's 734 and 735.
5 A I was looking for the trial balance, too. I
6 can't find that. If I recall correctly, there were direct
7 costs, there were indirect costs and then there would have
8 been management in general type costs specifically on their
9 trial balance.
10 Q All right.
11 A I can't find a copy of the trial balance in here,
12 so I don't have a reference for that.
13 Q All right. Let's move on. Turn to Page 00830.
14 A I'm there.
15 Q What does this particular work paper relate to?
16 A This relates to confirmations that would have
17 been sent out for accounts receivable. It also looks like
18 attorney letters are here, also.
19 Q Do you know what other types of confirmations
20 were made with respect to the 1996 audit?
21 A Specifically for that audit I don't recall if we
22 would have set anything up for like a debt confirmation for
23 the bank, I don't know.
24 Q But these are just the confirmations for accounts
25 receivable, again looking at 00830?

Page 123

1 A Yes, that's right.
2 Q So confirmations were only sent out to these
3 entities listed on 830?
4 A That's what this is saying.
5 Q Is there a work paper that indicates the basis
6 for selecting eight accounts receivable?
7 A 00943.
8 Q Can you explain work paper 00943 for me?
9 A Basically starting out, took the total from their
10 accounts receivable report, which was on Page BS 00942.
11 Q Uh-huh?
12 A And added in year end accruals, took out their
13 old receivables and came up with a total trade accounts
14 receivable and then the line, it looks like 3,086,750
15 rounded was the total of those six jobs that we confirmed
16 and we indicated that we're confirming 87 percent of the
17 total receivables.
18 Q Job site visits, were there any made in
19 connection with the 1996 audit?
20 A No, not that I'm aware of.
21 Q Were there any confirmations that were sent out
22 to subcontractors?
23 A Not that I'm aware of.
24 Q Now, you'd agree with me that with respect to the
25 -- excuse me. Where is the work paper that relates to the

Page 122

1 accounts payable confirmations?
2 A I don't recall that we confirmed any accounts
3 payable.
4 Q You did not confirm any accounts payable. Is
5 that a standard auditing procedure with respect to the audit
6 of CCI?
7 MS. CARSON: Object to the form.
8 THE WITNESS: We would have done a search for
9 accounts payable for invoices that would not have been
10 recorded, but should have been recorded.
11 BY MR. McGLYNN:
12 Q Was there a search for so-called unrecorded
13 liabilities?
14 A I'm sure there was. Do you want me to find that
15 page?
16 Q If you could, that would be great.
17 A It looks like BS 01006.
18 Q 301 --
19 A -- 006.
20 Q That goes on to 007, correct?
21 A Yes.
22 Q Now, you indicated just a few minutes ago that
23 there were no confirmations sent out to subcontractors,
24 correct?
25 A Not that I remember.

Page 123

1 Q Do you recall ever doing that in connection with
2 any audit while you were employed by Brown Schultz or
3 Laventhol?
4 MS. CARSON: Objection to the form.
5 THE WITNESS: I don't recall.
6 BY MR. McGLYNN:
7 Q Do you know what confirmations to subcontractors
8 would tend to show?
9 A I don't know exactly what would be put on the
10 confirmation to a subcontractor.
11 Q All right. And job site visits, you indicated
12 none were done in 1996, correct?
13 A Not that I'm aware of.
14 Q And do you know if anyone from Brown Schultz
15 interviewed any of the project managers or the project
16 supervisors for CCI to determine the status of jobs in 1996?
17 A We would have talked to -- I don't know the exact
18 title -- but there would have been specific people, specific
19 CCI employees that would have been in charge of each job;
20 plus I remember Stan Sechrist, I believe he was in charge of
21 all jobs.
22 Q Can you point to a work paper in 1996 to show
23 those people that you talked to concerning the status of
24 jobs in progress or the completed jobs?
25 MS. CARSON: I'll object to the form of that

DEBORAH BOWMAN
MAY 21, 2002

Multi-Page™

Page 174

1 Q You may answer. You selected 25 job costs to
 2 test direct costs in 1997, correct?
 3 A Yes.
 4 Q And to determine whether or not management's
 5 estimated costs to complete in 1997, what tests did you
 6 perform?
 7 A We looked at estimated costs to complete from two
 8 jobs that were completed in the year that were in -- that
 9 had been in process in the previous year. We would have
 10 talked to the client.
 11 We would have also looked at subsequent costs,
 12 meaning costs that were incurred in January of the previous
 13 year which would be January 1998 through whatever, February
 14 10th or whatever that date is, to determine what kind of
 15 costs had come in subsequent to the end of the year to see
 16 if it was reasonable compared to the estimated costs that we
 17 were given to complete the job.
 18 Q And where is the work paper that shows the
 19 subsequent events testing that you performed with respect to
 20 those job costs?
 21 A I haven't found the work paper yet, but it's
 22 referenced as R 6-B on 02230 where we say see R 6-B for
 23 comparison of actual cost incurred subsequent to year end
 24 and the estimated cost to complete the job as of 12/31/97.
 25 Q You're just having trouble finding R 6-B?

Page 175

1 A I am. It might be 02232. It's very difficult to
 2 read. It looks as if the total cost is the total cost.
 3 Again, I wish I could read the date. I believe it says
 4 2/5/98, but I can't read it correctly.
 5 Q You believe that this particular document, 02232
 6 shows the actual costs that were incurred from January 1 to
 7 whatever your cut off date was?
 8 MS. CARSON: Object to the form.
 9 BY MR. McGLYNN:
 10 Q 1998?
 11 A I believe the total cost column is that, yes.
 12 Q Let me see if I can find where is the total cost
 13 column on this -- I see it. 1,779,089?
 14 A Right.
 15 Q Now -- strike that. No site visits were
 16 performed in 1997, were they, for the 1997 audit, were they?
 17 A Not that I'm aware of.
 18 Q And to your knowledge the only person that Brown
 19 Schultz talked to at least as reflected in these work papers
 20 concerning the progress of jobs was Stan Sechrist?
 21 MS. CARSON: I object to the form.
 22 THE WITNESS: That's what was documented on that
 23 work paper, but there may have been -- again, he was in
 24 charge of all of the jobs; so he would have had direct
 25 knowledge of all of the jobs in process.

Page 176

1 BY MR. McGLYNN:
 2 Q And did Sechrist report to Shane Miller?
 3 A I believe so.
 4 Q And was there any work paper that indicated that
 5 Stan Sechrist's estimates were reasonable?
 6 MS. CARSON: Object to the form.
 7 THE WITNESS: I guess I would refer back to the
 8 -- our test of the estimated costs to complete.
 9 BY MR. McGLYNN:
 10 Q And -- just so I understand again the tests
 11 concerning the estimated cost to complete, were a testing of
 12 the two -- two out of the eight completed jobs in 1997?
 13 MS. CARSON: Object to the form, mischaracterizes
 14 her testimony.
 15 BY MR. McGLYNN:
 16 Q You may answer.
 17 A We looked at two completed jobs.
 18 Q Now -- off the record.
 19 (Discussion held off the record.)
 20 BY MR. McGLYNN:
 21 Q Let's turn, please, to BS 02008. It's the
 22 balance sheet. And can you point out two things, the
 23 accounts receivable current and retained. Is there a work
 24 paper or series of work papers that show how those
 25 receivables were tested?

Page 177

1 A Again, as in the previous year, we would have
 2 confirmed the receivables. It starts with 02181 and 02182.
 3 That's the total accounts receivable ageing report as of
 4 12/31/97. And then it looks like we took -- there's a
 5 little calculation here on the side where it starts with 9
 6 million.
 7 Q On 2182?
 8 A Yes. I'm guessing that.
 9 MS. CARSON: Don't guess.
 10 THE WITNESS: It's the right. It would be the
 11 total receivable, which would be the balance and the
 12 retained to get to a total trade accounts receivable -- I
 13 can't remember the number. The 9.3 million dollar number.
 14 We confirmed 8.6 million of that or 92 percent of that
 15 balance.
 16 Q All right. And those are pursuant to the written
 17 confirmations that appear in the work papers?
 18 A Right.
 19 Q All right. Now, can you point to the --
 20 A Are we back on 2008?
 21 Q Very good. Yes, we are. The under billings,
 22 costs and estimated earnings in excess of billings on
 23 uncompleted projects 1,072,281. Do you see that?
 24 A Yes.
 25 Q Is there a work paper that relates to those under

Page 218

1 included in the contract amount because they -- the profit
2 analysis showed that the profit was insignificant, correct.
3 MS. CARSON: Object to the form.
4 THE WITNESS: No.
5 BY MR. McGLYNN:
6 Q The fact that they were unapproved standing alone
7 would have meant that they should not have been included in
8 revenue, correct?
9 MS. CARSON: Object to the form.
10 BY MR. McGLYNN:
11 Q You may answer.
12 A Just because they were pending change orders, it
13 might have meant that the owner -- there was a time lag
14 between when the change order was sent to the owner and when
15 the owner sent a signed change order back.
16 Q All right. But you indicate, for example, on
17 00250 for the Lord Fairfax project that these were
18 unapproved?
19 MS. CARSON: Is there a question?
20 BY MR. McGLYNN:
21 Q Correct?
22 A Unapproved meaning the copy, the pending change
23 orders is what I'm saying.
24 Q Well, no, I'm looking at 31,742. Do you see that
25 on BS 00250?

Page 219

1 A Say the number again.
2 Q 31,742?
3 A Yes.
4 Q Do you see that?
5 A Yes.
6 Q You say it's unapproved, correct?
7 A I'm saying that the 76,000 that we subsequently
8 knew was approved because of the payment certificate that
9 came in, we were left with 31 left and we determined that
10 the effect was insignificant and did not perform additional
11 procedures.
12 Q All right. But standing alone if the change
13 order is not approved, it can't be booked as revenue?
14 MS. CARSON: Object to the form.
15 BY MR. McGLYNN:
16 Q Correct?
17 A I don't recall the specifics of the PPC -- if
18 it's -- if it is an unapproved change order. I don't recall
19 the specifics involved with that.
20 Q And there's nothing else on this particular work
21 paper, BS 00250 that indicates that it's pending or that it
22 might be approved in a month or anything, it just says it's
23 unapproved, correct?
24 MS. CARSON: Objection to form.
25 BY MR. McGLYNN:

Page 218

1 Q You may answer.
2 A Again, it was the significance of the dollar
3 number.
4 Q Is there any work paper that indicates there was
5 any kind of an analysis of whether or not it could have been
6 approved or -- strike that -- could have been booked as
7 revenue under -- as you testified the PPC guidelines?
8 A I don't recall.
9 Q So the only analysis that appears on that work
10 paper and the other work paper for the Albermarle project
11 was the significance or insignificance of the amount?
12 MS. CARSON: Object to the form.
13 MR. McGLYNN: Correct?
14 MS. CARSON: Object to the form, it
15 mischaracterizes her testimony.
16 MS. CARSON: Objection to the form.
17 THE WITNESS: I'm still unclear about what your
18 total question is.
19 BY MR. McGLYNN:
20 Q All right. So you don't understand my question?
21 A I'm not sure of your question.
22 Q The analysis that is reflected in those two work
23 papers for Lord Fairfax and Albermarle concerning the
24 unapproved component of the change orders only concerns
25 itself to whether or not the unapproved amount is

Page 219

1 significant or insignificant, correct?
2 A Yes.
3 Q All right. There is no analysis as to whether or
4 not the unapproved change order could be booked as an asset
5 in accordance with PPC guidelines?
6 MS. CARSON: Object to the form.
7 THE WITNESS: Again, an insignificant number.
8 BY MR. McGLYNN:
9 Q No site visits in 1998, correct?
10 A Not to my knowledge.
11 Q And you never sent out -- Brown Schultz never
12 sent out any confirmations to subcontractors in terms of how
13 much was owed?
14 A Not to my knowledge.
15 Q And was there any independent analysis made as to
16 the percentage of completion of the work in progress other
17 than your discussions with Stan Sechrist?
18 MS. CARSON: Object to the form.
19 THE WITNESS: We did other work on the work in
20 process schedule as we talked about for the prior two years.
21 BY MR. McGLYNN:
22 Q Right. But you didn't go out and talk to the
23 owner or interview --
24 A The owner of the --
25 Q -- project?

USF&G vs Brown

Multi-Page™

Stephen H. Salazar
5/22/02

UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF PENNSYLVANIA

Civil Action No. 1:01-CV-00813

-----X
UNITED STATES FIDELITY AND :
GUARANTY COMPANY, :
:

Plaintiff, :
:

- vs - :
:

BRUCE J. BROWN and BROWN, SHUTLZ, :
SHERIDAN & FRITZ, :
:

Defendants. :
-----X

Deposition Testimony of STEPHEN SALAZAR

1631 North Front Street
Harrisburg, PA

May 22, 2002
10:00 a.m.

IT IS HEREBY STIPULATED and agreed that the
reading, sealing, and signing of the within
transcript are waived;

IT IS FURTHER STIPULATED and agreed that all
objections except as to the form of the question
are reserved to the time of trial.

LEARY REPORTING
112 West Main Street, Ste. 200
Mechanicsburg, Pennsylvania 17055

(717) 233-2660 Fax (717) 691-7768

USF&G vs Brown

Multi-Page™

Stephen H. Salazar
5/22/0

Page 98

1 Those are the main ones.

2 Q Was the financial statement used to

3 evaluate whether to allow an exception to the

4 program parameters -- start over.

5 Was the financial statement from

6 the outside accountants used in deciding whether

7 to allow exceptions to the program parameters

8 for CCI Construction?

9 MR. McGLYNN: Objection.

10 A The financial statement review is

11 part of the underwriting of the particular job,

12 as well as the experience of the contractor and

13 the particulars of the job.

14 Q Was there other financial

15 information which you used in the underwriting

16 process other than the financial statement from

17 the outside accountant?

18 A We would occasionally review

19 interim, in-house statements.

20 Q How often did you have or receive

21 interim financial statements?

22 A I don't recall with CCI, but I

23 believe we got a six-month statement and maybe

24 quarterly. I am not 100 percent certain on

25 that.

Page 99

1 Q Why did you get that financial

2 information?

3 A You want to obtain interim

4 information so that you can see how the

5 contractor is doing during the course of the

6 year; because you only get the CPA year-end

7 statement once a year.

8 Q Was there a concern that the CPA

9 financial statement was not an accurate picture

10 of the financial condition of the company for

11 that period after the financial statement was

12 issued?

13 MR. McGLYNN: Objection.

14 A You obtain the interim information

15 just to determine how he is doing since the

16 year-end statement was prepared.

17 Q Did you consider the interim

18 internal financial statement information to be

19 accurate?

20 A As far as I know, it was accurate.

21 Q Did you rely on the interim

22 financial information in making underwriting

23 decisions for the bond program for CCI

24 Construction?

25 A We would use the interim

Page 100

1 information just to confirm that there has not

2 been material changes from the CPA year-end.

3 Q Does that mean, yes, you used the

4 interim financial information in making

5 underwriting decisions for the bond program for

6 CCI Construction?

7 A Yes, in conjunction with the CPA

8 year-end statement, yes. We used both.

9 Q Will you agree an interim financial

10 statement which was for a period ending eight

11 months prior to the date on which the bond was

12 under consideration for issuance would not be an

13 accurate reflection of the then present

14 financial condition?

15 MR. McGLYNN: Objection.

16 A It could. However, like I said,

17 you want to see independent CPA verification as

18 a confirmation that the numbers are, indeed,

19 accurate.

20 Q For how long a period of time did

21 you rely on the year-end financial statement

22 issued by outside accountants after the issuance

23 date as an accurate reflection of the financial

24 condition of the company?

25 A You would use the CPA year-end

Page 101

1 statement as the base point in determining the

2 financial condition of the company. And you

3 would use interims just to confirm if there were

4 any material changes from the year-end.

5 Q So wasn't it essential to get the

6 interim financial information to determine

7 whether there was a change since the year-end

8 financial statement was produced?

9 A It is not vital, but it is helpful.

10 Q It is not vital to receive interim

11 information to determine whether a material

12 change from the year-end financial statement has

13 occurred?

14 A You can have some accounts where

15 you do not get interim information; but like I

16 said, it is helpful to have interim information.

17 Q It possible as of the date of the

18 interim -- isn't it the situation that the

19 financial statement only reflects the financial

20 condition of the company as of the closing date

21 on that financial statement?

22 MR. McGLYNN: Objection.

23 A Repeat that, please.

24 Q Did you understand that a financial

25 statement created by outside accountants

USF&G vs Brown

Multi-Page™

Stephen H. Salazar
5/22/0

Page 246

1 MR. McGLYNN: Objection.
2 A You need to repeat that one.
3 Q To what extent was there a
4 tolerance in the underwriting to modifications
5 to the information included within the
6 description of operations, working capital,
7 balance sheet, and work in progress as reflected
8 on Exhibit 7 for the 1994 annual review before
9 it would be significant to the underwriting
10 process?
11 A I don't understand what you mean by
12 a tolerance.
13 Q If the amounts expressed on the
14 1994 review change by \$1, you would agree that
15 that would not be significant to underwriting,
16 wouldn't you?
17 A Yes.
18 Q So wouldn't you agree that the
19 change in information would have to be --
20 wouldn't just be any change to be significant to
21 underwriting, would it?
22 MR. McGLYNN: Objection.
23 A It is all relative to what program
24 you are going on. I mean, \$10,000 could be
25 significant depending on what size of account or

1 change?

2 Q Did any of the information included
3 in Salazar Exhibit 8, which was the annual
4 review you prepared for 1995 --

5 MR. McGLYNN: 1994.

6 MR. McCARRON: No. 8 is 1994.

7 MR. McGLYNN: You just said it was
8 1994 about a minute ago. So it's now
9 1995?

10 Q Let me start over.

11 Did any of the information which is
12 included in Salazar Exhibit 8, which is the
13 annual review statement or report you prepared
14 for 1995, concerning CCI Construction change in
15 any manner materially significant to
16 underwriting from the 1994 information as
17 reflected in Salazar Exhibit 7?

18 A I would really have to look at it,
19 please. Repeat the question.

20 Q Is there any material change from
21 an underwriting standpoint between the
22 information reflected in Exhibit 8, which is the
23 1995 annual review, from the information which
24 you included in the annual review for 1994,
25 which is Exhibit 7?

Page 247

1 what account you are looking at.
2 Q For CCI Construction, sir, to what
3 extent would a change in amounts and other
4 information be tolerated before it had an impact
5 on underwriting?
6 A I can't determine that.
7 Q I am showing you Exhibit 8, which
8 is the 1994 annual review. Is that right?
9 A Yes.
10 Q And again, you prepared the 1995
11 annual review just like you prepared the 1994
12 annual review?
13 A Yes.
14 Q And incidentally, at the conclusion
15 of the 1994 annual review, you recommended the
16 continuation of approval for the bond program
17 for CCI Construction. Is that true?
18 A Yes.
19 Q Now, can you tell us whether any of
20 the information which is included in the annual
21 review you prepared for 1995, which is Exhibit
22 8, changed in any material respect from 1994 in
23 the annual review as expressed in Salazar
24 Exhibit 7?
25 A Say that again? Did anything

Page 2

1 MR. McGLYNN: Objection.

2 A My opinion is there is not a
3 material change, no.

4 Q Can you tell us the extent to which
5 the information included in Exhibit 8 would have
6 to change in order to be material from an
7 underwriting standpoint?

8 MR. McGLYNN: Objection.

9 A I can't determine exactly what
10 material is -- what material would be for it to
11 change.

12 Q So you can't tell us how much the
13 values which are included within Exhibit 8 would
14 have to change before would it become
15 significant from an underwriting standpoint. Is
16 that right?

17 MR. McGLYNN: Objection.

18 A I would say if it was a change of a
19 couple million dollars or something, that would
20 be a material change. I am not giving you an
21 exact amount because -- comparing the program of
22 the work and the financial capacity of the
23 contractor, what is material and what is not
24 material changes from account to account.

25 Q With the CCI account, how much

JAMES DAILEY

1

IN THE UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF PENNSYLVANIA
(Harrisburg Division)

UNITED STATES FIDELITY : CIVIL ACTION
and GUARANTY COMPANY :
:
-VS- : JUDGE KANE
:
BRUCE BROWN and BROWN :
SCHULTZ SHERIDAN & :
FRITZ : NO. 1:01-CV-00913

Oral deposition of JAMES
DAILY, taken at the Law Offices of SWARTZ,
CAMPBELL & DETWEILER, 1601 Market Street,
34th Floor, Philadelphia, Pennsylvania
19103, on Thursday, April 18, 2002,
commencing at or about 10:08 a.m., before
Kristy Kupiec, a Certified Court Reporter
and Commissioner of Deeds.

REPORTING SERVICE ASSOCIATES (RSA)

A Veritext Company

1845 Walnut Street - 15th Floor
Philadelphia, Pennsylvania 19103

(215) 241-1000

JAMES DAILEY

<p style="text-align: right;">46</p> <p>1 determination of the treatment, we needed 2 to look at several other aspects of the 3 case. And these would lead to discussion 4 and ultimately an agreement as to how we 5 were going to treat certain items on the 6 balance sheet analysis. And if they didn't 7 agree, my position prevailed. 8 Q. What difference would it make then 9 whether the field office made a certain 10 determination even if it was different than 11 yours? 12 A. Well, their primary responsibility 13 is to produce the business. 14 Q. You are talking about the field 15 office? 16 A. That's right. 17 My primary responsibility is 18 to underwrite the business. Now, they had 19 underwriting responsibilities and I had 20 production responsibilities. But my 21 primary responsibility was to underwrite 22 and theirs was to produce. In the home 23 office you are not under pressure of 24 regular contact with either the agency or</p>	<p style="text-align: right;">48</p> <p>1 production efforts were agency 2 relationships and expertise. 3 Q. Were there any specific criteria 4 that you used in connection with 5 underwriting bond programs during the 1990s 6 for USF&G? 7 A. Yes. 8 Q. What were the criteria that you 9 used in connection with bond underwriting 10 for USF&G during the 1990s? 11 A. Well, we looked at working 12 capital, we looked at equity, we looked at 13 cash management, we looked at experience 14 for that type of job, the location of the 15 job, owner, financing, we looked at trends 16 extensively and the trends in the financial 17 analysis on the 4.80, and I don't think it 18 has a number but we looked at what they did 19 with their money, how they earned their 20 money, where they earned their most money, 21 whether they did better with public or 22 private work, small or large jobs. 23 Q. Were there any particular criteria 24 applied to the construction company bonds?</p>
<p style="text-align: right;">47</p> <p>1 the customer. So my analysis would have 2 been more objective rather than subjective 3 and affected by the relationships with the 4 agent or the customer. 5 Q. Well, in what manner did 6 underwriters produce business? 7 MR. McGLYNN: At the field 8 office? 9 MR. McCARRON: I'm sorry. 10 BY MR. McCARRON: 11 Q. In what manner did the field 12 office underwriters produce business? 13 A. Well, they had relationships with 14 producing agents. And if we could see eye 15 to eye in basic customer handling with an 16 agency, they would offer us new business, 17 new accounts that they picked up. But we 18 don't -- the field people didn't do any 19 direct production, the actual marketing 20 people were the independent insurance 21 agents who represent a number of companies. 22 Q. Number of surety companies? 23 A. Yes, surety companies. 24 So essentially their</p>	<p style="text-align: right;">49</p> <p>1 A. The ones I have just... 2 Q. Is there any particular item in 3 the criteria that is unique to underwriting 4 construction companies for bond purposes? 5 A. There is lots of classes for the 6 construction companies; you have general 7 builders, you have road contractors, you 8 have subcontractors, mechanical, 9 electrical, roofers, people that just do 10 concrete, people that don't do anything but 11 framing, floors, carpets, windows, doors. 12 There are all different kinds of businesses 13 and so you have different sorts of 14 criteria. Well, it's not criteria, it's a 15 different way of looking at, say, prime 16 contractors and subcontractors. Everyone 17 has to wait for the next person to be paid 18 before he gets paid. So there is a long 19 wait time for him to get his money. 20 When I started the surety 21 business with the bond contractors, all 22 surety is a result of the Miller Act of 23 1933 or '35 or something like that where 24 the federal government passed a law that</p>

JAMES DAILY

210

1 IN THE UNITED STATES DISTRICT COURT
2 FOR THE MIDDLE DISTRICT OF PENNSYLVANIA
3

4 UNITED STATES FIDELITY) DEPOSITION UPON
5 AND GUARANTY COMPANY)
6 Plaintiff) ORAL EXAMINATION
7 vs.) OF
8 BRUCE BROWN AND) JAMES DAILY
9 BROWN SCHULTZ SHERIDAN
10 & FRITZ)
11 Defendants)
12 -----

13 TRANSCRIPT OF CONTINUED
14 DEPOSITION, taken by and before MARGIE A. ROMEO,
15 Professional Reporter and Notary Public, at the
16 Law Offices of Swartz, Campbell & Detweiler, 1601
17 Market Street, 34th Floor, Philadelphia, PA on
18 Thursday, June 27, 2002 commencing at 10:20 a.m.
19 -----

20 REPORTING SERVICE ASSOCIATES (RSA)
21 A Veritext Company
22 1845 Walnut Street - 15th Floor
23 Philadelphia, PA 19103
24 (215) 241-1000

JAMES DAILY

<p style="text-align: right;">275</p> <p>1 Q. In what way would correct information 2 have effected the decisions by USF & G to bond or 3 issue bonds for CCI Construction? 4 A. Well, we probably wouldn't have given 5 them as much credit as they were getting. 6 Q. And how did you make that determination? 7 A. We didn't make that determination. 8 Q. How did you determine that you, that USF 9 & G may not have given CCI Construction as much 10 bond credit as was given to CCI Construction if 11 the financial statements had correctly reflected 12 the financial information relative to CCI 13 Construction? 14 A. Well, the amount of -- the amount of 15 credit you give is directly related to the 16 financial condition of the customer. 17 Q. Is that the end of your answer? 18 A. Yes. 19 Q. Did you determine or did anyone on behalf 20 of USF & G determine the extent to which the 21 credit for bonding extended by USF & G to CCI 22 Construction might have changed if the financial 23 statements had correctly reflected financial 24 condition of CCI Construction?</p>	<p style="text-align: right;">277</p> <p>1 of exactly what would have changed. I know it 2 would have changed. 3 4 BY MR. McCARRON: 5 Q. When you say you would have to see 6 restated financial information, you mean you 7 would have to see corrected or correct financial 8 statements which accurately reflected the 9 financial condition of CCI Construction during 10 the period involved? 11 A. Yes. 12 Q. Would you need to see information or 13 consider information in addition to the restated 14 financial statements in order to evaluate whether 15 and to what extent underwriting decisions would 16 have been effected by correctly presented 17 financial statements in the underwriting for the 18 CCI bond account? 19 A. Well, we would first have to see the 20 restated financial statements, then if we needed 21 additional information for clarification, we 22 might have asked for something else, but I can't 23 identify what it might have been because we don't 24 have that information.</p>
<p style="text-align: right;">276</p> <p>1 A. No. 2 Q. Are you able to tell us the extent to 3 which the bonding credit might have changed by 4 USF & G as extended to CCI Construction, if the 5 financial statements had correctly stated or 6 reflected the financial condition of CCI 7 Construction? 8 A. No. 9 Q. Why can't you tell us? 10 A. I would have to see the restated 11 financial statements first. 12 Q. If I could just ask a full question. 13 A. I thought you were through. 14 Q. I understand. I'm not blaming you. 15 Why can't you determine the 16 extent to which the credit for bonding extended 17 by USF & G might have changed for the CCI account 18 if the financial statements had correctly 19 reflected the financial condition of CCI 20 Construction. 21 MR. McGLYNN: Objection. 22 THE WITNESS: I would have to see 23 the restated information first, but even then I 24 don't think I could give you a definitive answer</p>	<p style="text-align: right;">278</p> <p>1 Q. In addition to the restated financial 2 statements, would your evaluation about the, 3 about whether the restated financial statements 4 would have had an impact on underwriting for the 5 CCI bond credited -- 6 MR. McGLYNN: Objection. 7 THE WITNESS: I'm lost. 8 MR. McCARRON: I am too. I'm 9 sorry. 10 --- 11 BY MR. McCARRON: 12 Q. Would you need to consider information in 13 addition to the restated financial statements in 14 order to determine whether and to what extent the 15 bond credit by USF & G might have been different 16 for CCI Construction? 17 MR. McGLYNN: Objection. 18 THE WITNESS: I don't know. 19 --- 20 BY MR. McCARRON: 21 Q. What I'm trying to understand, sir, is 22 would you have to review other information which 23 was already in the possession, perhaps of USF & G 24 and which had been taken into account during the</p>

JAMES DAILY

<p style="text-align: right;">383</p> <p>1 off-shore captive, which is not unheard of. It 2 is not common, but I think -- that's it. 3 4 BY MR. McCARRON: 5 Q. What I'm trying to understand, sir, do 6 you have any complaint about the information 7 which was disclosed by Brown Schultz concerning 8 the relationship between PCIC and CCI? 9 A. Not at the time. 10 Q. Well, do you now have any complaints in 11 retrospect about the information and adequacy of 12 the information reflected by Brown Schultz in the 13 financial statements for CCI Construction as it 14 relates to the relationship with PCIC? 15 A. Do I have any complaints, I don't have 16 any complaints. 17 Q. Well, do you believe the information 18 included within the financial statements prepared 19 by Brown Schultz for CCI Construction 20 inadequately reflected information about PCIC? 21 A. Well, I don't think -- 22 MR. McGLYNN: Objection. 23 THE WITNESS: I don't think it 24 was very good disclosure.</p>	<p style="text-align: right;">385</p> <p>1 move. 2 Q. Why do you say it would have been a smart 3 move? 4 A. Well, it was providing a guarantee to 5 CCI, and we should have known whether it could 6 keep its promises. 7 Q. Was it important to you -- was it 8 important to USF & G to know whether PCIC could 9 make good on the guarantee for payment to CCI? 10 A. I don't think we thought so at the time. 11 Q. You didn't think it was important to know 12 whether PCIC could make good on its guarantee? 13 A. Not at the time. 14 Q. Do you now believe it was important or 15 should have been important to know whether PCIC 16 could make good on its guarantee for payment to 17 CCI? 18 A. It would have been good information to 19 have, but I don't think it would have stopped the 20 loss. 21 Q. Does that mean it would not have 22 influenced whether USF & G committed to bonds for 23 CCI Construction? 24 MR. McGLYNN: Objection.</p>
<p style="text-align: right;">384</p> <p>1 2 BY MR. McCARRON: 3 Q. Was there more which you needed to know 4 about PCIC than as reflected in the financial 5 statements? 6 MR. McGLYNN: Objection. 7 THE WITNESS: There probably 8 was. 9 Q. I'm sorry? 10 A. It did not occur to us at the time. 11 Q. Did you ever ask any questions to learn 12 additional information about PCIC? 13 A. I don't think so. 14 Q. What information did you -- what 15 additional information did you want to know about 16 PCIC that is reflected in the financial 17 statements? 18 A. Well, we should probably have asked for a 19 financial statement. 20 Q. A PCIC financial statement? 21 A. Yes. 22 Q. You are saying USF & G should have asked 23 for a financial statement of PCIC? 24 A. In retrospect, it would have been a smart</p>	<p style="text-align: right;">386</p> <p>1 THE WITNESS: I don't think so. 2 3 BY MR. McCARRON: 4 Q. Do you know whether PCIC satisfied its 5 commitment on the guarantee to pay CCI certain 6 amounts? 7 A. I don't. Well, the footnote says they 8 paid \$845,000.00 one year, but I don't know about 9 the rest of it. 10 Q. Does that mean no, you don't know? 11 A. No, I don't know. 12 Q. If PCIC made good and its guarantee for 13 payment -- 14 A. Well, it made good on one because the 15 footnote says that. 16 Q. Does that mean no, you don't know whether 17 PCIC made good on all of its guarantees to CCI 18 Construction for payment? 19 A. I don't know. 20 Q. On Page 13 of Salazar exhibit 5, which is 21 the financial statement for the year ending 22 December 31, 1998, it appears the note Related 23 Party Transactions; is that right? 24 A. Yes.</p>

JAMES DAILY

<p style="text-align: right;">415</p> <p>1 as strong -- the financial condition of December</p> <p>2 31, '98 was going to be as strong also as the</p> <p>3 prior year.</p> <p>4 ---</p> <p>5 BY MR. McCARRON:</p> <p>6 Q. Why did you believe on January 5, 1998</p> <p>7 the financial condition of CCI Construction would</p> <p>8 be as good as the prior year?</p> <p>9 A. They told us that.</p> <p>10 Q. CCI Construction told you that?</p> <p>11 A. Yes.</p> <p>12 Q. Did you have any other information to</p> <p>13 confirm the financial condition of CCI</p> <p>14 Construction would be as good as the prior year</p> <p>15 as of January 5th, 1999?</p> <p>16 A. I don't think so.</p> <p>17 Q. So you relied on information received</p> <p>18 from CCI Construction concerning its financial</p> <p>19 condition when USF & G underwrote, committed to</p> <p>20 bond CCI Construction during January, 1999; is</p> <p>21 that right?</p> <p>22 MR. McGLYNN: Objection.</p> <p>23 THE WITNESS: I've lost you.</p> <p>24 What's the verb?</p>	<p style="text-align: right;">417</p> <p>1 Q. Okay. Were you aware in, that in 1997</p> <p>2 there were bonuses paid to the officers of CCI</p> <p>3 Construction?</p> <p>4 A. I don't remember.</p> <p>5 Q. Does the comment made in the second</p> <p>6 sentence of the second paragraph by Mr. Dominiani</p> <p>7 which says they, referring to USF & G asked me to</p> <p>8 send their congratulations to you and your</p> <p>9 management staff; is that an accurate reflection</p> <p>10 of USF & G's position?</p> <p>11 A. Well, I think that -- I think that was</p> <p>12 probably from Tony Phillips.</p> <p>13 Q. So that does not, Mr. Phillips' statement</p> <p>14 to Mr. Dominiani was not reflective of the</p> <p>15 enthusiasm of USF & G?</p> <p>16 MR. McGLYNN: Objection.</p> <p>17 THE WITNESS: He doesn't say who</p> <p>18 he met with. He said I had the opportunity to</p> <p>19 meet with USF & G. It could have been Tony</p> <p>20 Phillips. It could have been Dave Hussey. It</p> <p>21 was not me.</p> <p>22 ---</p> <p>23 BY MR. McCARRON:</p> <p>24 Q. Well, I'm just asking. Is that comment</p>
<p style="text-align: right;">416</p> <p>1 ---</p> <p>2 BY MR. McCARRON:</p> <p>3 Q. USF & G relied on financial</p> <p>4 representations or representations concerning</p> <p>5 financial condition for the coming year based on</p> <p>6 information -- USF & G relied on representations</p> <p>7 from CCI Construction about its financial</p> <p>8 condition when it decided to commit to bonding</p> <p>9 during January, 1999?</p> <p>10 MR. McGLYNN: Objection.</p> <p>11 THE WITNESS: Yes.</p> <p>12 MR. McCARRON: This has been</p> <p>13 marked Phillips-6.</p> <p>14 ---</p> <p>15 BY MR. McCARRON:</p> <p>16 Q. Sir, I'm showing you what has been</p> <p>17 previously marked Phillips-6. It is a letter</p> <p>18 from Mr. Dominiani to Mr. Ortenzio dated March 5,</p> <p>19 1998.</p> <p>20 Are you familiar with this, and</p> <p>21 it is bate stamped USF & G slash BS 0915.</p> <p>22 Are you familiar with this</p> <p>23 document, which is Phillips --</p> <p>24 A. I don't think so.</p>	<p style="text-align: right;">418</p> <p>1 that USF & G was extending congratulations to CCI</p> <p>2 in March of 1998 reflective of the sentiment of</p> <p>3 USF & G?</p> <p>4 A. Well, as I recall, '97 was a pretty good</p> <p>5 year. And whoever Dominiani met with, very</p> <p>6 likely asked him to extend their congratulations</p> <p>7 for another good year.</p> <p>8 Q. Okay. You see the next sentence where it</p> <p>9 says I understand that your operating profit, do</p> <p>10 you see that, sir?</p> <p>11 A. Yes.</p> <p>12 Q. Do you know who he's referring to in that</p> <p>13 letter?</p> <p>14 A. Well, this letter is dated March 5, 1998</p> <p>15 so it wouldn't have been the three percent, five</p> <p>16 percent discussed in the January, '99 meeting.</p> <p>17 So, no, I don't understand. I don't know what it</p> <p>18 refers to.</p> <p>19 Q. Does this letter, Phillips-6 refresh your</p> <p>20 recollection about whether there were minimum</p> <p>21 equity requirements or ratios of work program?</p> <p>22 What you are looking at, sir?</p> <p>23 A. Oh, this is Phillips-6. Does this</p> <p>24 refresh my recollection?</p>

ANTHONY S. PHILLIPS

1

3

4

UNITED STATES FIDELITY AND) DEPOSITION UPON
GUARANTY COMPANY,)

Plaintiff,) ORAL EXAMINATION

- VS -

BRUCE BROWN AND BROWN,) ANTHONY S.

SCHULTZ, SHERIDAN & FRITZ,) PHILLIPS

Defendants.

12

14

16

18

20

22

REPORTING SERVICE ASSOCIATES, (RSA)

1845 Walnut Street - 15th Floor

Philadelphia, Pennsylvania 19102

(215) 735-2332

ANTHONY S. PHILLIPS

<p style="text-align: right;">54</p> <p>1 financial information prepared by an -- a CPA 2 who is also an employee of CCI? 3 A. No. 4 Q. Was a bonding program approved by 5 USF&G for CCI Construction? 6 A. Yes. 7 Q. When did the approval occur? 8 A. Various times. 9 Q. Was there a specific program that was 10 developed with respect to limits and bonds? 11 A. Various programs. 12 Q. Okay. What was the first program for 13 bonds for CCI which was developed? 14 A. Honestly, I don't remember. There 15 were various amounts at various times. It 16 was a fluid situation as any large account 17 that Saint Paul or USF&G bonds may be. 18 Q. Okay. 19 A. Fluid from the standpoint on one piece 20 of criteria that we may have changed the form 21 to not halt a contractor. Additional pieces 22 of information of a substantial nature may 23 increase the bond program, even as much as on 24 a day-to-day or week-to-week basis depending</p>	<p style="text-align: right;">56</p> <p>1 better and verifiability better, jobs going 2 worse -- are verifiability worse. It changes 3 that quick at times based upon our 4 understanding of the information provided to 5 us either by a CPA or by internal sources. 6 Q. Did you -- let me start over -- once 7 USF&G approved a bonding program for CCI, was 8 approval in -- additional to -- approval for 9 the bonding program required for the issuance 10 of each and every bond by USF&G for CCI 11 Construction? 12 A. I believe there would -- is what is 13 called a working line setup on the account 14 given to the branch office that anything 15 falling within that criteria of the work line 16 per job, and program of work could be 17 approved by the branch based upon the 18 acquisition of all of the underwriting 19 information culminating with the year end 20 audit verifying the information that we had 21 on hand. 22 Q. So was it the situation that once the 23 bonding program was approved for CCI 24 Construction, then thereafter no further</p>
<p style="text-align: right;">55</p> <p>1 upon what kind of underwriting information 2 came in, the validity of the information, and 3 the verifiability of the information. 4 Q. What were the parameters in applying a 5 program initial list applied by USF&G for 6 CCI? 7 A. I answered that. I am not sure right 8 now as to whether or not it was a \$60 million 9 or \$75 million, because programs for large 10 contracts are fluid depending upon the type 11 of information that comes in, the job itself, 12 the knowledge of the contractor to the 13 particular obligee, and the overall financial 14 capacity of the contractor at the time. It 15 may be that a program that is set up for 60 16 million on a particular job well suited for 17 him, experienced by him, et cetera, you may 18 go up to one hundred million dollars the next 19 time. Which is a one-shot deal on a 20 particular job to go back to the \$60 million 21 unless a whole different set of criteria are 22 that -- are developed based upon additional 23 monies coming into the company, additional 24 monies leaving the company. Jobs going</p>	<p style="text-align: right;">57</p> <p>1 underwriting approval was required with 2 respect to the issuance of bonds for CCI 3 Construction within the parameters 4 established for the bonding program? 5 MR. McGLYNN: Objection as to 6 form. 7 THE WITNESS: No. There is 8 various levels of authority to execute 9 bonds. The branch office would still 10 have to underwrite the particular job, 11 see that the additional information 12 that would be coming in on status 13 reports on particular jobs saying how 14 they are doing direct from the 15 obligee. Seeing how the internal 16 information would tie in with the 17 previous audit that was done at year 18 end. And various other criteria would 19 have to be reviewed by the branch to 20 keep up with the line of authority 21 that the branch office was given by 22 the home office. 23 BY MR. McCARRON: 24 Q. And what was the line of the authority</p>

U.S. Fidelity v Bruce Brown

Multi-Page™

Anthony Phillips
6/20/02

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

U.S. FIDELITY and GUARANTY CO. :
 :
 :
-VS- : NO. 1-01-CV-00813
 :
 :
BRUCE BROWN & BROWN, SCHULTZ, :
SHERIDAN, & FRITZ, :

Volume III

DEPOSITION OF: ANTHONY S. PHILLIPS

BEFORE: Michelle S. Parke,
Court Reporter

PLACE: 1631 North Front St.
Harrisburg, Pa

BEGINNING: June 20, 2002
10:10 a.m.

APPEARANCES:

BERNKOPF, GOODMAN, & BASEMAN, LLP
BY: PETER B. McGLYNN, ESQUIRE
125 Summer Street
Boston, Massachusetts 02110-1621

For - Plaintiff

SWARTZ, CAMPBELL, & DETWEILER
BY: JEFFREY McCARRON, ESQUIRE
1601 Market Street, 34th floor
Philadelphia, Pennsylvania 19103-2337

For - Defendants

Leary Reporting (717) 233-2660

U.S. Fidelity v Bruce Brown

Multi-Page™

Anthony Phillips
6/20/02

Page 440

1 Q Did you share Phillips 7 with Jim Daily?
 2 MR. McGLYNN: Objection. I don't
 3 understand what you mean by share. Did you give him a
 4 copy?
 5 MR. McCARRON: Yes.
 6 MR. McGLYNN: Ask it that way.
 7 BY MR. McCARRON:
 8 Q Did you share it would be the same.
 9 Either give him a copy, hand it to him, the original
 10 you received or otherwise?
 11 A Could be. I am not sure.
 12 Q How would we determine whether you shared
 13 Phillips Exhibit 7 with Jim Daily?
 14 A If you got a copy of this information
 15 from Jim Daily.
 16 Q Did you discuss the information, which is
 17 included in Phillips Exhibit 7 with Mr. Daily?
 18 A I don't remember.
 19 Q Did you have an understanding about the
 20 phrase or the sentence in the third paragraph on the
 21 first page of Phillips Exhibit 7, "CCI can actually use
 22 this as a buffer to offset losses or profit fades in
 23 certain jobs during any given year", referring to PCIC?
 24 A I didn't think of it at the time.
 25 Q Did it occur to you that CCI Construction

Page 441

1 was suggesting it could use money from PCIC to improve
 2 its financial condition and offset losses or profit
 3 fades?
 4 MR. McGLYNN: Objection.
 5 THE WITNESS: I didn't think of it at the
 6 time.
 7 BY MR. McCARRON:
 8 Q Does that sentence now suggest to you
 9 that CCI Construction was indicating it could use PCIC
 10 money to improve its financial condition by offsetting
 11 losses and profit fades?
 12 MR. McGLYNN: Objection.
 13 THE WITNESS: That they were using what
 14 kind of funds did you say?
 15 BY MR. McCARRON:
 16 Q PCIC funds.
 17 MR. McGLYNN: Objection.
 18 THE WITNESS: Possibly.
 19 BY MR. McCARRON:
 20 Q Does that sentence have any other
 21 significance to you?
 22 A No.
 23 Q Did you personally review all of the
 24 financial statements in the ordinary course of business
 25 for CCI Construction?

Page 442

1 MR. McGLYNN: Objection.
 2 THE WITNESS: What do you mean by review?
 3 BY MR. McCARRON:
 4 Q Receive and review the information which
 5 is included. Actually review the financial statements.
 6 A I can say I read the financial
 7 statements.
 8 Q Did you read all of the financial
 9 statements for CCI Construction as they were received
 10 in the ordinary course of business in connection with
 11 the underwriting?
 12 A Yes.
 13 Q The last time, sir, you told us that you
 14 didn't look at the financial statement for 1998. Have
 15 you changed your answer?
 16 A Did I specifically say I did not look at
 17 the financial statement at all or I did not analyze the
 18 financial statement?
 19 Q You did not read the financial statement
 20 for 1998.
 21 A I would look at every financial statement
 22 that came in. Read every financial statement to me
 23 would mean every part of the financial statement. It
 24 possibly could be 1998 I did a peripheral read and
 25 asked my underwriter to do a more thorough read and

Page 443

1 then a more thorough analysis. That's the only reason
 2 I could say I would give an answer that I didn't read
 3 the 1998 financial statement.
 4 Q Are you able to tell us that you reviewed
 5 in detail the financial statements for every year for
 6 CCI Construction?
 7 MR. McGLYNN: Objection. That's not what
 8 he said.
 9 THE WITNESS: No.
 10 BY MR. McCARRON:
 11 Q Did you evaluate the financial statements
 12 for CCI Construction for every year?
 13 MR. McGLYNN: Objection.
 14 THE WITNESS: Again, what do you mean by
 15 evaluate?
 16 BY MR. McCARRON:
 17 Q Did you personally review and evaluate
 18 the financial statement for CCI Construction as they
 19 were received in the ordinary course of business in
 20 underwriting for CCI Construction?
 21 MR. McGLYNN: Objection.
 22 THE WITNESS: Not fully.
 23 BY MR. McCARRON:
 24 Q Isn't it the case that the bear flags for
 25 CCI Construction were never considered green?

U.S. Fidelity v Bruce Brown

Multi-Page™

Anthony Phillips
6/20/02

Page 460

1 BY MR. McCARRON:

2 Q Showing you page 7 of the financial
3 statement for CCI Construction for 1996, which is
4 identified as Salazar Exhibit 2 and under footnote 1
5 which is on page 7, it indicates use of estimates, does
6 it not?

7 A Yes.

8 Q It explains that in certain circumstances
9 the values expressed in the financial statements are
10 based on estimates, doesn't it?

11 A No, not in certain circumstances. I
12 don't see that.

13 Q Does the footnote relating to the use of
14 estimates indicate an explanation about the use of
15 estimates?

16 A Yes.

17 Q Do you understand what is indicated under
18 use of estimates, which is in footnote 1 of the
19 financial statement?

20 A Pretty much.

21 Q Did you understand that those instances
22 in which the amounts are reflected as estimates, that
23 they are indeed estimates and that actual results could
24 differ from those estimates?

25 A Estimates given by management to the

Page 461

1 auditor, yes.

2 Q Did you understand that the values
3 expressed as estimates were only estimates and that the
4 actual results could differ from those amounts
5 reflected as estimates?

6 A Yes.

7 MR. McGLYNN: It's just 10 after now.

8 BY MR. McCARRON:

9 Q What specific changes to the financial
10 statements of CCI Construction would have changed your
11 underwriting decision?

12 MR. McGLYNN: Objection.

13 THE WITNESS: I can't say. It's too
14 vague a question.

15 BY MR. McCARRON:

16 Q What changes to the financial statement
17 of CCI Construction have changed your underwriting
18 decision?

19 MR. McGLYNN: Is that a question?

20 Objection.

21 THE WITNESS: Would you repeat the
22 question?

23 BY MR. McCARRON:

24 Q Would changes to the financial statement
25 of CCI have changed your underwriting decision?

Page 462

1 A Would changes have --

2 MR. McGLYNN: Objection. You may answer.

3 THE WITNESS: -- changed my decision,
4 yes.

5 BY MR. McCARRON:

6 Q What changes to the financial statement
7 would have changed your underwriting decision?

8 MR. McGLYNN: Objection.

9 THE WITNESS: That's too broad a
10 question. I couldn't say.

11 BY MR. McCARRON:

12 Q Were there any changes to the financial
13 statement for CCI Construction, which have effected
14 your underwriting decision for only some bonds?

15 MR. McGLYNN: Objection.

16 THE WITNESS: I will answer it this way:

17 Any changes to financial statements would change my
18 underwriting of an account depending upon the extent to
19 which the changes effected the financial condition of
20 any firm.

21 BY MR. McCARRON:

22 Q How would you determine whether a change
23 to the financial statement of an account was
24 significant enough to effect your underwriting
25 decision?

Page 463

1 A That's too broad a question.

2 Q Can you determine whether a change to a
3 financial statement would have been significant enough
4 to have changed your underwriting decision?

5 MR. McGLYNN: Can he?

6 MR. McCARRON: Yes, can he.

7 MR. McGLYNN: Is he capable of doing
8 that?

9 MR. McCARRON: Yes.

10 THE WITNESS: Yes.

11 BY MR. McCARRON:

12 Q What would you need to know in order to
13 evaluate and determine whether a change to a financial
14 statement was significant enough to have changed your
15 underwriting decision?

16 A I would need to know the degree of change
17 upward or downward and the working capital and equity,
18 what effect this had on existing work, how the existing
19 work changed in profitability, how the existing work
20 had receivables that were not to be received, and how
21 all other related information that I previously
22 referred to, like other work-in process, bank credit,
23 the relationship of the change to other jobs and
24 process would effect it.

25 Q Can you make a determination about

U.S. Fidelity v Bruce Brown

Multi-Page™

Anthony Phillips
6/20/02

Page 464

1 whether changes to financial statements for CCI
2 Construction would have been material to your
3 underwriting decision without the benefit of restated
4 financial statement?

5 A I could not.

6 Q Have you prepared restated or corrected
7 financial statements for CCI Construction?

8 A No.

9 Q Do you know whether there exists
10 corrected or restated financial statements for CCI
11 Construction?

12 A I believe there are.

13 Q Have you reviewed restated financial
14 statements for CCI Construction?

15 A No.

16 Q Who has the restated or corrected
17 statements for CCI Construction?

18 MR. McGLYNN: If it involves any
19 discussions between counsel, I am instructing the
20 witness not to answer.

21 THE WITNESS: I think I couldn't say.

22 BY MR. McCARRON:

23 Q Do you plan to review restated or
24 corrected financial statements for CCI Construction?

25 MR. McGLYNN: Objection.

Page 465

1 THE WITNESS: I don't know at this point.

2 BY MR. McCARRON:

3 Q How will you determine whether you will
4 review stated or corrected financial statements for CCI
5 Construction?

6 MR. McGLYNN: Objection.

7 THE WITNESS: It's too vague a question
8 for me to give a proper answer to.

9 BY MR. McCARRON:

10 Q Under what circumstances are you going to
11 review restated or corrected financial statements?

12 MR. McGLYNN: Objection.

13 THE WITNESS: I never thought of that or
14 planned to at this particular point.

15 BY MR. McCARRON:

16 Q Have you determined whether any of the
17 criticisms expressed in the answers by USF & G to
18 interrogatories which were identified as Phillips 3
19 would have changed your underwriting decision?

20 MR. McGLYNN: Objection. That's been
21 covered in day 2 rather thoroughly.

22 MR. McGLYNN: And it's quarter after.

23 You can answer this last question.

24 THE WITNESS: Probably.

25 BY MR. McCARRON:

Page 466

1 Q I asked you: Did you determine whether
2 any of the problems or criticisms identified in Answers
3 to Interrogatories, which is identified as Phillips
4 Exhibit 2 would have changed your underwriting
5 decision?

6 A The question must be restated. I don't
7 understand the question.

8 Q Did you determine whether any of the
9 information which is criticisms by USF & G about the
10 financial statement by Brown Shultz would have changed
11 -- which is included in Answers to Interrogatories,
12 which is identified as Phillips 2 -- would have changed
13 your underwriting decision?

14 MR. McGLYNN: Objection.

15 THE WITNESS: Possibly.

16 BY MR. McCARRON:

17 Q So does that mean you did not determine?

18 A Was I the expert who determined this?

19 Q No. No. Did you determine whether the
20 information included in Phillips Exhibit 2 would have
21 changed your underwriting decision in connection with
22 CCI Construction bonds?

23 A Yes, it would have changed.

24 Q Did you make that determination, sir,
25 that the information included in Phillips 2 would have

Page 467

1 changed your underwriting decision in connection with
2 CCI Construction bonds?

3 A Was I asked to make that?

4 Q No. Did you?

5 A In my mind?

6 Q Did you make a determination about
7 whether the information included in Phillips Exhibit 2,
8 which is answers by USF & G to interrogatories, would
9 have changed -- if you had known about it at the time
10 -- would have changed your underwriting decision for
11 CCI Construction bonds?

12 A Yes.

13 Q How did you determine whether the
14 information included in Phillips 2 which was answers to
15 interrogatories by USF & G would have changed your
16 underwriting decision?

17 A By the substantial change in working
18 capital and equity.

19 Q Do the answers to interrogatories, which
20 are identified as Phillips 2, reflect substantial
21 changes should have been made to working capital and to
22 equity?

23 A Yes.

24 Q Identify where in the answers it shows
25 that working capital and equity would have materially

David Hussey - 5/28/02

1

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

UNITED STATES FIDELITY
and GUARANTY COMPANY

Plaintiff

vs.

CIVIL ACTION NO:
NO. 1-01-CV-00813

BRUCE BROWN and BROWN,
SCHULTZ, SHERIDAN & FRITZ

Defendants

The deposition of DAVID HUSSEY was held on
Tuesday, May 28, 2002, commencing at 10:00 A.M., at the
Law Offices of The St. Paul Companies, 5801 Smith
Avenue, Baltimore, Maryland 21209, before Ronda J.
Thomas, Notary Public.

APPEARANCES:

PETER B. MCGLYNN, ESQUIRE
On behalf of Plaintiff

JEFFREY B. MCCARRON, ESQUIRE
On behalf of Defendants

REPORTED BY: Ronda J. Thomas, RPR

David Hussey - 5/28/02

<p style="text-align: right;">106</p> <p>1 MR. McGLYNN: Objection.</p> <p>2 Q -- and I'm sorry, I was going to blame you</p> <p>3 for making me lose, but I don't think I can.</p> <p>4 MR. McGLYNN: The problem is you hesitate</p> <p>5 about three or four seconds and I interpret that as</p> <p>6 meaning you ended the question.</p> <p>7 MR. McCARRON: If I close my mouth, I think</p> <p>8 I'm done.</p> <p>9 MR. McGLYNN: Very rarely you have closed</p> <p>10 your mouth.</p> <p>11 MR. McCARRON: I'll try to make the effort</p> <p>12 of actually closing my mouth.</p> <p>13 MR. McGLYNN: Why don't we start again.</p> <p>14 Q Did your decision to allow bonding for CCI</p> <p>15 for jobs which included self-performed work which CCI</p> <p>16 had previously subcontracted, let me start again.</p> <p>17 Was your decision to approve bonding for</p> <p>18 CCI for jobs which involved self-performed work by CCI</p> <p>19 which CCI had previously subcontracted based on your</p> <p>20 belief CCI could properly self-perform the work which</p> <p>21 it had previously subcontracted?</p>	<p style="text-align: right;">108</p> <p>1 themselves.</p> <p>2 Q Mr. Daily was the source of your</p> <p>3 information about the amount of money which CCI had at</p> <p>4 stake when you decided to approve bonding for CCI for</p> <p>5 jobs which included self-performed work?</p> <p>6 MR. McGLYNN: Objection.</p> <p>7 A Yes.</p> <p>8 Q Do you know the source of Mr. Daily's</p> <p>9 information about the amount of money which CCI had at</p> <p>10 stake when you approved the bonds for CCI for jobs</p> <p>11 which included self-performed work?</p> <p>12 A We have been through this. It was his</p> <p>13 knowledge of the financials, conversations with the</p> <p>14 region, that's where he would have developed any</p> <p>15 understanding about the CCI account.</p> <p>16 Q Region being Mike Walter?</p> <p>17 A No. It would have been --</p> <p>18 Q Harrisburg field office?</p> <p>19 A Harrisburg field office.</p> <p>20 Q Do you agree USF&G during 1990s was a</p> <p>21 sophisticated user of financial statements in its</p>
<p style="text-align: right;">107</p> <p>1 MR. McGLYNN: Objection.</p> <p>2 A Yes.</p> <p>3 Q What led you to believe CCI could properly</p> <p>4 and adequately self-perform work which it had</p> <p>5 previously subcontracted which led to your decision to</p> <p>6 approve bonding for CCI for jobs which included</p> <p>7 self-performed work?</p> <p>8 A Their track record and that the management</p> <p>9 team was intact. The management team had made some</p> <p>10 hires.</p> <p>11 Q Is that your complete answer?</p> <p>12 A Yes.</p> <p>13 Q Can we rule out then financial condition</p> <p>14 and the amount of money which CCI had as a factor</p> <p>15 which -- on which your decision to approve bonding for</p> <p>16 CCI for jobs which involved self-performed work by CCI?</p> <p>17 A No.</p> <p>18 MR. McGLYNN: Objection.</p> <p>19 A That would be -- again, they would have the</p> <p>20 money to lose. That they had more than enough at stake</p> <p>21 if they made their own mistake, they'd be hurting</p>	<p style="text-align: right;">109</p> <p>1 underwriting?</p> <p>2 MR. McGLYNN: Objection.</p> <p>3 A What do you mean by sophisticated?</p> <p>4 Q Was USF&G sophisticated user of financial</p> <p>5 statements --</p> <p>6 MR. McGLYNN: Objection.</p> <p>7 Q -- in its underwriting for bonding?</p> <p>8 MR. McGLYNN: How do you define</p> <p>9 sophistication.</p> <p>10 MR. McCARRON: I'm asking.</p> <p>11 MR. McGLYNN: Why don't you ask him how he</p> <p>12 defines sophistication then. Let's move this along.</p> <p>13 There are time limits on these depositions and, you</p> <p>14 know, you've asked questions --</p> <p>15 MR. McCARRON: Stop using my time, please.</p> <p>16 MR. McGLYNN: Then ask the question</p> <p>17 properly.</p> <p>18 MR. McCARRON: Stop using --</p> <p>19 MR. McGLYNN: Do it in a succinct manner --</p> <p>20 MR. McCARRON: Knock it off. You know I</p> <p>21 don't listen to what you have to say, I never will, I'm</p>

David Hussey - 5/28/02

<p style="text-align: right;">102</p> <p>1 the day after the effective date or the closing date of 2 the financial statement; is that true? 3 A It reflects -- the financial statement is 4 the day and time that reflects the condition of the 5 company as of that specific date and time. 6 Q And not thereafter? 7 A Not thereafter. 8 Q You agree that a favorable financial 9 condition as of the closing date or last date of the 10 financial statement period could be remarkably 11 different than the ensuing financial condition 12 following the closing date or last date included within 13 the financial statement period? 14 MR. McGLYNN: Objection. 15 A It could. But not -- it doesn't 16 necessarily follow that. 17 Q What did you or anyone else at USF&G do to 18 make sure your understanding about the financial 19 condition of CCI Construction on whether it was 20 profitable, operated on a deficit, gaining or losing on 21 its net worth, increasing equity, had a favorable cash</p>	<p style="text-align: right;">104</p> <p>1 MR. McCARRON: I'm sorry. 2 MR. McGLYNN: You used the word bonds 3 plural. The only one I've heard about is Fulkrod. I'm 4 just trying to move this along. If you intended to use 5 the word bonds plural. 6 MR. McCARRON: Okay. I'm going to try 7 again because I don't know what you're talking about. 8 A If he doesn't know what you're talking 9 about, I don't know what you're talking about. 10 MR. McCARRON: I don't know what he's 11 talking about. 12 MR. McGLYNN: I'm not trying to be an 13 obstructionist, for the last three-quarters of an hour 14 we have been working about the Fulkrod project and 15 Mr. Hussey's decision to approve a bond for that 16 project. 17 MR. McCARRON: Not so, sir. Not if you 18 listen to his answers. He doesn't know if it was in 19 connection with the Fulkrod project. 20 MR. McGLYNN: I'm not talking about his 21 answers, I'm talking about your questions.</p>
<p style="text-align: right;">103</p> <p>1 position was correct since the issuance of the 1990 or 2 the last date included within the 1997 financial 3 statement when you made the determination not to accept 4 the recommendation of Mr. Daily and authorized the 5 continuation of the bonding of CCI by USF&G? 6 MR. McGLYNN: Objection. 7 A The discussion that Jim and I would have 8 would center around where we were, where we are and 9 where we're headed. And you would take into 10 consideration how much money they had, the competency 11 of the management and your track record with the firm. 12 Meaning do they accomplish what they set out to do or 13 don't they. 14 Q Just to be clear, your evaluation of 15 Mr. Daily's opinion not to approve the bonds for CCI 16 during December 1998 took into account how much money 17 CCI Construction had, the track record experience by 18 USF&G with CCI and the experience of CCI's management; 19 is that right? 20 MR. McGLYNN: Objection, I think you used 21 the word bonds?</p>	<p style="text-align: right;">105</p> <p>1 Q Now, you're not able to say that 2 Mr. Daily's opinion against approval for bonds for CCI 3 once you learned CCI planned to self-perform work it 4 had previously subcontracted was limited to the bonds 5 for Fulkrod project, are you? 6 MR. McGLYNN: Objection. 7 A No, I'm not. 8 Q Did your evaluation of the opinion 9 expressed by Mr. Daily not to approve bonding for CCI 10 for projects which involved self-performed work by CCI 11 which had previously been subcontracted take into 12 account any factors other than the amount of money 13 which CCI had the track record of management and the 14 experience which USF&G had with CCI? 15 A Yes, I believe they could do it. He 16 believed they couldn't. That's as simple as that gets. 17 Q Well, ultimately did the decision by you to 18 approve bonding for CCI Construction for jobs which 19 involved self-performing work which CCI had previously 20 subcontracted come down to your belief that CCI could 21 adequately do the job?</p>

27 (Pages 102 to 105)

Byerly

Insurance

AGENTS AND BROKERS, INC.

DAVID A. DOMINIANI
EXECUTIVE VICE PRESIDENT

525 North 12th Street
P.O. Box 525
Lemoyne, PA 17043-0525
(717) 761-4010
1-800-872-1127
FAX (717) 761-4320

November 7, 1997

Mr. John Ortenzio
President
CCI Construction Co., Inc.
203 Lynndale Court
Mechanicsburg, PA 17055-2893

Re: Bonding Requirements

Dear John:

As you are aware, our current bonding program with USF&G requires your corporate balance sheet to maintain an equity level of no less than \$4,800,000. To clarify, this means that your net equity position cannot fall, at any time, below \$4,800,000 or your bonding program may be put on hold. I realize that this will require you to maintain additional equity above and beyond \$4,800,000 to take into consideration the seasonal and monthly fluctuations in profitability. It is critical that you maintain these levels based on our agreement with USF&G.

If you have any questions, please feel free to contact me.

Sincerely,



David A. Dominiani, CPA
Executive Vice President

DAD/sz

cc: Bruce Brown

BY 00500

CCI CONSTRUCTION CO., INC.

Written Consent of Shareholder
in Lieu of Special Meeting

August 27, 1997

I, the undersigned, being the sole Shareholder of CCI CONSTRUCTION CO., INC., a Pennsylvania corporation, do hereby consent in writing, pursuant to the applicable provisions of the Pennsylvania General Association Act of 1988, as amended, and the Corporation's Bylaws, to the adoption of the following resolutions hereinafter set forth and direct that they shall, in all respects, be deemed as valid actions as though such actions and resolutions had been duly approved and authorized at a joint special meeting of the Shareholder.


WHEREAS, the Shareholder has determined it to be in the Corporation's best interest for the Shareholder to be released of any personal indemnity for surety bonding purposes; therefore, Shareholder has agreed to maintain the equity level of the Corporation no less than \$4,800,000 and require an aggregate work program no higher than \$60,000,000. If the work program requirements of the Corporation consistently go above the \$60,000,000 level and/or the equity level fall below \$4,800,000, Shareholder understands that United Fidelity and Guaranty Company reserves the right to discuss the potential need to reinstate personal indemnity.

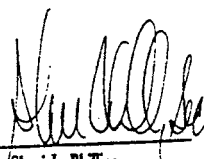
NOW, THEREFORE, BE IT RESOLVED, that the foregoing resolution is hereby approved and authorized this 27th day of August, 1997.

Sole Shareholder:

CCI CONSTRUCTION CO., INC.

By


John M. Ortenzo
Director/President


Sheri L. Phillips
Secretary

Year Ended	Equity > \$4,800,000	Sales < \$60 million	Compliance achieved	Prepared by			
12/31/97	\$5,500,000	\$35,000,000	✓	CPR 2/5/98			

BSSF 1890

BS 01853

4. Describe specialized accounting practices or principles applicable to client's industry:

90% OF COMPLETION TO RECOGNIZE REVENUE

5. Describe special regulatory or reporting requirements that apply to companies in client's industry:

N/A

6. Describe special regulatory or reporting requirements, for example, SEC, that apply to client:

N/A

7. List primary users of the financial statements:

Name	Relationship to client
CITICAT FINANCIAL	LENDERS
USF&G (Saint Paul)	SURETY/BONDING
DEWITT'S BANK	BANK
MANAGEMENT	
BIDS	

8. Basis of accounting used for financial reporting:

☒ Accrual ☐ Cash ☐ Income tax ☐ Other (describe) 90% OF COMPLETION

9. Who are the principal accounting and EDP personnel? List:

Name	Title or Function	Responsible for:
Steve Evans	Controller	
DEBRA BUCKNER	TRK MER	
JIM CROWLEY	CHIEF OF ACCOUNTING	
SHERRI PHILLIPS	SEC / TREAS / CFO	
DEB KOFFO	ADMINISTRATIVE	
DEBRA MAGNIE		
JACKIE RUDOLPH	PAYROLL / FOODS. P.E.C.	
FRANK L. LARSEN	ACCT. PAY / SUBMITTALS	
Nancy Dethlefs	ASST. PAY	
SUE BISHOP	ACCOUNTING ASSISTANT	
KEITH FRUCHTL	ACCOUNTING ASSISTANT	

BS 01590

BSSF 1626

CHECKLIST FOR EVALUATING BUSINESS RISK AND
OVERALL INHERENT AND AUDIT RISKCLIENT CCI Construction Co, Inc. PERIOD ENDED 12/31/96

PART I: BUSINESS RISK FACTORS

Business risk is considered in the audit process in connection with client acceptance or retention decisions and in determining audit scope as follows:

- In selecting the desired precision level of the audit and, therefore, materiality (factors involving user needs and expectations)
- In selecting a maximum acceptable audit risk level, used in conjunction with assessed inherent and control risk factors, to determine detection risk.

In completing PART I, indicate the presence or absence of a risk factor by checking the box at the right. (Complete the column at the right in accordance with the instructions in PART II after completing PART I.)

		YES	NO	PART II CODE
A. FACTORS INDICATING HIGHER AUDIT PRECISION LEVELS (LOWER MATERIALITY) (Some of these may also require reducing APM levels below 1/3 of MTM; see Form B-3.)				
1.	Are the client's securities publicly held?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	—
	If yes:	<input checked="" type="checkbox"/> N/A		
a.	Are they widely held?	<input type="checkbox"/>	<input type="checkbox"/>	—
b.	Are securities holders primarily institutional?	<input type="checkbox"/>	<input type="checkbox"/>	—
c.	Are securities heavily traded (high volume), or have unusually volatile prices or high or low price/earnings ratio?	<input type="checkbox"/>	<input type="checkbox"/>	—
d.	Is there evidence of significant attention to client's financial statements and affairs by securities analysts, stock exchanges or the SEC?	<input type="checkbox"/>	<input type="checkbox"/>	—
2.	Is the client planning or contemplating a public (or private) offering of securities?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	—
3.	Is the client planning or contemplating a sale of the business or a significant portion thereof, has there been recently, or is there likely to be soon, a significant change in ownership interests?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	—
a.	If yes, will the sale price be dependent, or subject to adjustment based upon amounts to be reported in the financial statements?	<input checked="" type="checkbox"/>	<input type="checkbox"/>	N/A
4.	Are there (or will there likely be) significant creditors who are financial statement users? <i>BANK IS FIN USER - NO FUNDS DRAWN ON ECC / CROWING CO. IS ALSO FIN.</i>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	0
	If yes:	<input type="checkbox"/> N/A User		
a.	Are there (or will there likely be) debt covenant tests related to the financial statements, compliance with which will likely be relatively marginal or uncertain?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	—
b.	Has the client had less than satisfactory relationships with its lenders?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	—
5.	Are there indications of significant or unusual related party transactions, possible irregularities or illegal acts, transactions questionable as to business purpose, or other potentially user-sensitive matters? <i>TRANSACTIONS WITH RELATED PARTIES DO OCCUR HOWEVER, THEY ARE NOT CONSIDERED SIGNIFICANT OR UNUSUAL.</i>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	—
6.	Have the client's financial statements or affairs received, or are they likely to receive, unusual scrutiny by financial statement users, regulators (other than stock exchanges or the SEC) or litigants? <i>USERS' MEETING, BANK - CROWING CO. - NO UNUSUAL SCRUTINY.</i>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	—
7.	Will our work be subject to review by a regulatory agency, litigant or a principal auditor?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	—
8.	Will we likely be succeeded by another audit firm?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	—
9.	Other? _____	BSSF 1061		
		<input type="checkbox"/>	<input checked="" type="checkbox"/>	—

CCI CONSTRUCTION CO., INC.

**Written Consent of Shareholder
in Lieu of Special Meeting**

August 27, 1997

I, the undersigned, being the sole Shareholder of CCI CONSTRUCTION CO., INC., a Pennsylvania corporation, do hereby consent in writing, pursuant to the applicable provisions of the Pennsylvania General Association Act of 1988, as amended, and the Corporation's Bylaws, to the adoption of the following resolutions hereinafter set forth and direct that they shall, in all respects, be deemed as valid actions as though such actions and resolutions had been duly approved and authorized at a joint special meeting of the Shareholder.

WHEREAS, the Shareholder has determined it to be in the Corporation's best interest for the Shareholder to be released of any personal indemnity for surety bonding purposes; therefore, Shareholder has agreed to maintain the equity level of the Corporation no less than \$4,800,000 and require an aggregate work program no higher than \$60,000,000. If the work program requirements of the Corporation consistently go above the \$60,000,000 level and/or the equity level fall below \$4,800,000, Shareholder understands that United Fidelity and Guaranty Company reserves the right to discuss the potential need to reinstate personal indemnity.

NOW, THEREFORE, BE IT RESOLVED, that the foregoing resolution is hereby approved and authorized this 27th day of August, 1997.

Sole Shareholder:

CCI CONSTRUCTION CO., INC.

By


John M. Ortenzio
Director/President


Sheri L. Phillips
Secretary

Note that all audit evaluations are made with respect to projected misstatement. If PART III, line 5, exceeds line 6, results are unacceptable. Also, if any individual proposed adjustment listed, or the total in column B on line 18 in either PART I or II, exceeds line 6, results may be unacceptable (if user-sensitive financial statement line items are materially misstated). Also, if the column B total on line 18 for the direction opposite the primary direction of risk (if any) exceeds 50% of the amount on line 6, it could mean we have underassessed inherent risk in the opposite direction (or we have misdetermined the primary direction) and should consider whether more auditing in the opposite direction is warranted. Comment in PART VI regarding such results, and indicate what further action, if any, is taken, or if none is needed, why not.

PART IV: RE-EVALUATION OF MAXIMUM TOLERABLE MISSTATEMENT (MTM) AND ACCEPTABLE PROJECTED MISSTATEMENT (APM)

- | | |
|---|----------------------|
| 1. a. Original planning materiality base (Form B-3, line 3) | <u>\$ 45,000,000</u> |
| b. 80% of line 1a | <u>\$ 36,000,000</u> |
| c. 120% of line 1a | <u>\$ 54,000,000</u> |
| d. Total audited revenue | <u>\$ 52,534,453</u> |
| e. Total audited assets | <u>\$ 24,614,448</u> |

If the greater of line 1d and 1e is less than line 1b, a recomputation of MTM and APM, subject to any further adjustment indicated in line 2, is necessary for evaluation purposes. If the greater of line 1d and 1e exceeds line 1c, a recomputation of MTM and APM, subject to any further adjustment indicated in line 2, is permissible, if necessary, for evaluation purposes.

2. Based on all information obtained during the course of the audit, I have reviewed the business risk factors in PART IA of Form B-2, reconsidered the audit precision level selected on Form B-3, line 1, and decided that the MTM percentage originally selected on Form B-3 (line 4) should (check one):
- a. ☒ remain the same. b. ☐ be changed to _____% for the following reason(s):

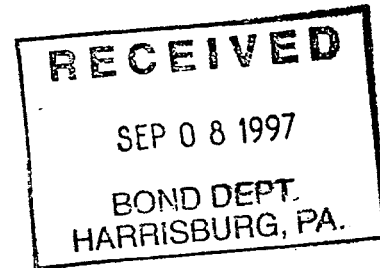
3. If box 2b is checked, recompute MTM and APM (as per lines 4 and 5 of Form B-3). N/A ☒
- If you have reason to believe that client's materiality base for the next audit period will be significantly smaller than the current audit period (indicating the possibility that the current period's waived adjustments will cause material misstatement in the succeeding period), recompute APM (but not MTM), N/A ☒
- or if client is resisting further adjustments, and you nevertheless believe the financial statements would not be materially misstated if APM were adjusted upward (to a maximum of 50% of MTM, subject to appropriate approval), recompute APM (but not MTM). N/A ☒
- Enter results below: N/A ☒

a. Revised MTM \$ _____ b. Revised APM \$ _____ (to PART III, line 6)

4. If revised MTM is lower than the original MTM, indicate below how audit scope has been (or will be) increased as a result, or if not, why not (if more space is needed, attach separate memorandum): N/A ☒

5. If special presentation and disclosure APM thresholds are needed, refer to, review and revise (if necessary) or prepare Form B-3A (line 1) and compare results appropriately on a separate attachment to Form B-10. N/A ☒

BSSF-2209



September 5, 1997

Mr. Anthony S. Phillips
Bond Manager
United States Fidelity and
Guaranty Company
Post Office Box 188
Harrisburg, PA 17108-0188

*Noted
T.P.*

Dear Tony:

I understand as part of our agreement to release my personal indemnity for surety bonding purposes, I will maintain the equity level of CCI Construction Co., Inc. no less than \$4,800,000 and require an aggregate work program no higher than \$60,000,000. Should the work program requirements consistently go above the \$60,000,000 level and/or the equity level fall below \$4,800,000, I understand that USF&G reserves the right to discuss the potential need to reinstate personal indemnity.

Sincerely,

CCI CONSTRUCTION CO., INC.

A handwritten signature in dark ink, appearing to read "John M. Ortenzio".

John M. Ortenzio
President

cc: David A. Dominiani
Byerly Insurance Agents and
Brokers, Inc.

USFG/BS 0908

CCI CONSTRUCTION CO., INC.

Mailing Address:
P.O. Box 1129
Mechanicsburg, PA 17055-1129
Telephone: (717) 691-3600

Street Address:
203 Lynndale Court
Mechanicsburg, PA 17055-2893
FAX: (717) 796-9300



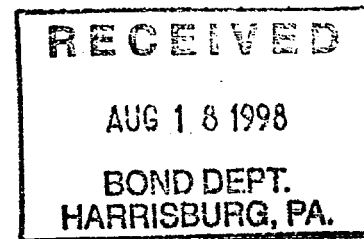
Associates, Inc.

(717) 441-1600
Fax (717) 441-1605

DAVID A. DOMINIANI, CPA
President

August 17, 1998

Mr. Tony Phillips
USF&G
2605 Interstate Drive, Suite 200
P.O. Box 188
Harrisburg, PA 17108-0188



Re: CCI Construction - Financial Projections

Copy to H.O. 803 D. 8/18/98
SS

Dear Tony:

As we discussed in detail, I am submitting for your review CCI Construction Company, Inc.'s internal financial statements for the six months ended June 30, 1998. As you are aware, they are off to a significantly slow start for 1998, but the outlook is to finish the year strong. Their projections at this time are to achieve \$60,000,000 in revenue and, as you can see, they have only generated \$17,000,000 through the first half of the year. There were some profit fades on some jobs in the beginning of 1998, specifically the Mahanoy and Houtzdale Prisons which were caused by common issues. I will explain that in further detail later on.

As you are aware, the company is going through some significant changes, building their capabilities in both the mechanical and civil areas. They have invested substantially in equipment and are about to finance approximately \$2,000,000 worth of that equipment over four years through CIT. That will improve the cash position once again.

As you can see, CCI is reflecting a \$1,600,000 loss through six months. However, they will turn that number around by 12/31/98. I have included with this report the profit projections by project for 1998. Please kind in mind that these numbers are conservative and suggest that the projected loss from operations in 1998 will be approximately \$200,000. This will be offset by investment income and in addition, please remember that we have PCIC available to fund warranty claims if we choose to utilize it. As you are aware, we funded almost \$900,000 into PCIC last year for warranty coverages on existing projects. There is approximately \$2,000,000 funded into that insurance vehicle and can be drawn on for warranty claims at any time. CCI can actually use this as a buffer to offset losses or profit fades on certain jobs during any given year. That is an additional feature that none of my other contractors have available to them.

As you can see for 1998, the projected overhead is going to be approximately \$3,200,000 of which \$700,000 is depreciation. In 1997, in total, CCI only had \$150,000 depreciation. In addition to the depreciation increase, CCI has staffed up with professionals in the

Mailing Address: P.O. Box 1362, Camp Hill, PA 17001-1362
1023 Mumma Road, Lemoyne, PA 17043

USFG/BS 0924

Mr. Tony Phillips
August 17, 1998
Page 2

mechanical and civil areas so that they can self perform that work in the future. They see that as giving them not only a competitive advantage on existing general construction jobs, but also will diversify them into other opportunities.

With respect to the Mahanoy and Houtzdale Prison projects, the majority of the problem was a mechanical subcontractor, Bennett Heating & Air Conditioning, that went out of business in the middle of those jobs. Bennett had quoted both prisons and they were currently doing a fine job on the UEPH project. CCI was forced to jump in and self perform on both of those jobs and it cost them a significant amount of money. There were also profit fades and/or poor estimates on the pre-engineer piping (the underground portion), the pump packages, the utility work and there was also a mason problem on Mahanoy Prison. As usual, CCI managed through these processes in an effective manner, but obviously cost them some significant dollars. There was about \$500,000 in profit fades on those two jobs alone reflected in 1998.

The additional loss is strictly caused by CCI being unable to bill work in the beginning of 1998. However, the good news is that they have a solid profitable backlog as of this date and their projections for profits for the second half of the year appear to be conservative. Please keep in mind above all else that we have a solid long term track record with CCI in managing their way through these processes. They continue to have a very solid balance sheet and we will continue to meet the minimum equity requirements that we have discussed previously. John Ortenzio is well aware of those commitments and will do whatever is necessary to assure us that they will be satisfied including utilizing PCIC.

I appreciate your continued support of John and his fine organization. We are in a growth mode and going through a transition in building up the mechanical and civil areas of the organization. I have no concerns or doubts about CCI being able to meet the projections that we have suggested. We will be getting additional internal financial information along the way to monitor their progress in 1998. Thanks again for your support and should you have any questions, please feel free to contact me at your convenience.

Sincerely,



David A. Dominiani, CPA
President

USFG/BS 0925

DAD/sz
Enclosures

CCI - PROJECTED PROFIT ANALYSIS

JOB NUMBER	CONTRACT VALUE	PROJECTS	TOTAL						
			G/P	PROJECTED	1996	1997	1998	1999	TOTAL
454	14,321,036	ALBEMARLE PRISON	1,808,809		0	0	818,338	980,471	1,808,809
435	45,556	BIENVILLE FAC BLOXI	25,847		0	17,347	8,500	0	25,847
421	2,397,292	CAPITAL ELECTRICAL	727,965		482,126	247,799	(1,960)	0	727,965
442	731,888	CAPITAL PORTCOES	94,683		0	89,607	5,076	0	94,683
418	7,783,855	CAPITAL SPRINKL-A	1,773,180		1,654,398	216,351	(97,559)	0	1,773,180
436	191,713	CAPITAL SPRINKL-H	12,721		0	13,582	(881)	0	12,721
437	1,304,525	CAP RENOV-WINDOW	115,197		0	140,136	(24,839)	0	115,197
460	15,500,000	GERMPLASM CTR	830,000		0	0	203,553	726,447	830,000
445	10,636,510	HOUTZDALE PRISON	(345,760)		0	(82,935)	(262,805)	0	(345,760)
450	3,266,600	JOHNSTOWN TRAFFIC	35,739		0	1,052	18,609	16,078	35,739
451	5,981,396	LORD FAIRFAX	458,418		0	31,503	389,713	37,202	458,418
439	11,017,675	MAHANAY PRISON	(429,640)		0	(234,619)	(195,021)	0	(429,640)
461	3,850,000	OUTLOOK-Chesterfield	256,000		0	0	157,235	88,765	256,000
448	4,600,214	OUTLOOK-Creekview	218,836		0	33,165	185,671	0	218,836
456	5,235,000	OUTLOOK-HILLIARD	53,500		0	0	426,256	144,802	53,500
453	204,940	PA TURNPIKE COMM	1,265,120		0	0	24,524	28,976	1,265,120
455	12,791,714	PERRY POINT-AID	821,897		0	0	553,785	711,335	821,897
459	13,598,277	SCOTT A F BASE	(35,913)		0	4,800	612,888	209,008	(35,913)
449	1,414,420	UEPH - CD HQTRS.	1,837,313		0	1,885,254	(40,713)	0	1,837,313
426	19,080,288	U.E.P.H. (includes Barracks)	350,000		0	0	(47,941)	0	350,000
462	5,200,000	WESTERVILLE, OHIO	788,250		0	0	123,985	226,005	788,250
	17,765,000	ESTIMATED WORK	80,622		0	0	63,050	725,200	80,622
		MISCELLANEOUS			0	0	80,622	0	
	<u>158,017,889</u>	<u>TOTAL</u>	<u>11,413,852</u>		<u>2,136,524</u>	<u>2,363,022</u>	<u>3,000,017</u>	<u>3,914,289</u>	<u>11,413,852</u>

EST OVERHEAD FOR 1998...

PROJECTED LOSS ON OPERATIONS IN 1998

USFG/BS 0926

10:08 AM 8/14/96

SUMMARY/REMARKS

USF&G INTEROFFICE CORRESPONDENCE

DATE: 4/15/98

TO: H.O. Surety, Jim Daily, Mail Code: LB0202

FROM: Harrisburg Surety Dept., Steve Salazar

SUBJECT: CCI Construction Company, Inc. - Annual Review
Stress Score as of 3/97: 29 (Yellow)
Bear Flags: A20-Gross Profit Fade Factor is greater
than 20%; M01-Equity less than 10% of Total Program.

Review of the 12/31/97 CPA audit on CCI Construction Co.
prepared by Brown, Schultz, Wormleyburg, Pa.

Principles of Accounting: Income is reported on the
percentage of completion, cost to cost basis, while the
company has elected Subchapter S. Corp. status for federal
tax reporting purposes. Effective January 1, 1995, the
company re-established itself as a Pennsylvania corporation
and changed its name to CCI Construction Company, Inc.

Depreciation is provided using an accelerated method over the
estimated useful lives of the respective assets.

Background: Business started in 1990 by the current principal
and was a spin-off of Commercial Construction, Inc., with all
assets and liabilities being transferred from Commercial
Construction, Inc. to CCI Construction Co. CCI is general
contractor specializing in the construction of and renovation
of hospitals and healthcare facilities. The company is also
involved in the general construction of institutional and
commercial buildings and operates in the contiguous United
States. John Ortenzio is the president and 100% owner. He
has 23 years experience in construction and has been the
president of CCI for over 10 years. Shane Miller is the Sr.
Vice president and Chief Operating Officer and has been with
the company since May of 1991. He has been an executive in
construction for over 10 years working previously for Howard
Elec./Mech., Denver, Co.; Leon Wintermyer, Lemoyne, Pa.; and
Campbell Resign Group, St. Louis, Mo. Dave Barber is Chief
Financial Officer and has been with CCI since 1986. Prior to
joining CCI he was comptroller for a rehab. hospital in
Pleasant Gap, Pa.

Continuity: The business is 100% owned by John Ortenzio.
He has a \$1,000,000 key-man life policy payable to the
construction company and working trusts set up for continuity
purposes in his will.

Operations: Sales increased from \$24,466,000 last year to
\$34,922,000 this year, an increase of \$10,456,000. Gross
Profit increased from \$1,319,000 last year to \$2,304,000 this
year. The Gross Margin increased from 5.4% to 6.6%. Due to
the increase in sales, G&A expenses showed a corresponding
increase from \$1,180,000 last year to \$1,954,000 this year.
This resulted in income from operations increasing from
\$139,000 last year to a \$302,700 this year. Investment

USFG/BS 1252

income also increased from \$275,000 to \$368,000. The increase in income from operations and investment income resulted in a significant increase in net profit from \$363,000 last year to \$707,000 this fiscal year-end.

Working Capital: Working capital decreased slightly from \$4,281,000 last year to a still strong \$3,965,000. This was due to purchases of additional equipment during the year. Please note that the contractor's working capital remains highly liquid consisting of cash and cash equivalents of \$1,128,000 and marketable securities of \$3,703,000.

Balance Sheet: Account remains in a strong financial position with working capital of \$3,965,000 and net worth of \$5,454,800. The Debt/Equity ratio increased from (1.0 to 1) to (2.07 to 1.) due to an increase in accounts payables and equipment debt. All material receivables are fully collectable. Cash and marketable securities totaled \$4,831,000 and CCI was borrowing zero on the \$1,000,000 working capital line of credit.

Work-in-Progress: Profits are being maintained on WIP. The gross margin on work-in-progress is 4.5%. The Fade Factor A Flag was due to the losses on the \$10,289,000 Mahanoy Prison and \$10,357,000 Houtzdale prison projects. All other projects in progress and completed in 1997 were profitable.

	<u>12/31/97</u>	<u>12/31/96</u>
Total Contract Price	\$55,747,000	\$ 31,120,000
Revised Gross Profit	\$ 2,502,000	\$ 4,162,000
Gross Margin	4.5%	13.4%
Backlog	\$26,191,000	\$ 17,599,000

Long-term Debt: No long-term debt.

Contingent Liabilities: None.

Affiliates: None. Medcom Resource Corporation and CRI General Contractors are no longer active related companies.

Bank Relations: CCI continues to have a strong relationship with their bank, Dauphin Deposit, Harrisburg, Pa. Dauphin Deposit has established an unsecured working capital line of credit in the amount of \$1,000,000 at the bank's prime rate.

Relations: Account has been with USF&G since 1993 and continues to be one of the Harrisburg Branch Office's premiere accounts. During 1997, 9 final bonds were written generating contract bond premiums of approximately \$218,000. A history of the account reveals a single job consideration of \$62,000,000 on the DGS Houtzdale State Correctional Institution when the account was acquired. The largest total work program consideration was \$117,000,000 which also occurred when the previously mentioned \$62,000,000 project was approved. The contractor has actually assumed total work programs in the \$75,000,000-\$80,000,000 range during 1994.

Insurance: Byerly Insurance Agency handles both the insurance and bonds. The account has adequate insurance in place.

Recommendations: The Harrisburg Branch Office strongly recommends the continuance of the Merit Rate approval on the account and renewal of our Specific Discretionary Authority of single job \$15,000,000 and \$75,000,000 total work program.

USFG/BS 1254

Byerly

Insurance

AGENTS AND BROKERS, INC.

July 21, 1994

525 North 12th Street
P.O. Box 525
Lemoyne, PA 17043-0525
(717) 761-4010
1-800-872-1127
FAX (717) 761-4320

STEVE SALAZAR
USF&G BOND DEPT
3211 N FRONT STREET
HARRISBURG PA 17110

JUL 25 1994

RE: CCI Construction Company

Dear Steve:

I met with Dave Barber, Shane Miller, and Doug McAninch from CCI yesterday to discuss the questions in your July 14, 1994 letter. With respect to the profit fades listed in your memo, please understand the time frame we are talking about. The most significant reason for these profit fades is the extreme winter weather, which caused delays, extra costs, and significant inefficiencies on all of these jobs. In addition, please keep in mind that CCI takes a very conservative approach in preparing their work in progress reports. Shane Miller informed me that on the NCI, and ABE Airport projects there are additional revenues and/or change orders which will be processed sometime in the future. All of the additional costs are built into the estimates, but there are no projections for the revenues that will be received for these additional change orders.

On the Bloomsburg B-1 project, there were several delays and problems created by the owner. However, since this was one of CCI's first local projects, they decided not to pursue recovery of additional costs due to goodwill and reputation issues with the owner. CV Middle School is a similar issue. Beyond the major weather issue, CCI is a multiple prime, and several other prime contractors have created some problems and delays. Since this is a very visible local project, CCI is willing to absorb some of the additional costs to preserve goodwill and future opportunities.

With respect to the gross margin being very thin on many projects, I don't think that surprises any of us. As you are well aware, CCI is totally reliant on the competitive bid arena in 1994, and although they have been very competitive, the realization is that the margins, if you are to be a successful low bidder, are extremely thin.

In reaction to the low profit margins, CCI has taken drastic measures with respect to overhead. The 12/31/93 CPA prepared financial statements, if you combine the G & A costs and

USFG/BS 0870

Steve Salazar

July 21, 1994
Page 2

the indirect costs, the total overhead for 1993 was \$4,000,000. The total overhead for 1994 is approximately \$2,500,000 if you combine G & A and indirect. This represents a \$1,500,000 reduction in overhead costs for the year. In addition to closing down their California operation, CCI has streamlined the Mechanicsburg workforce and cut overhead in almost every major category. I think that our initial confidence in John Ortenzio and his management team are truly evident in 1994 when these measures need to be taken quickly and completely.

Dave Barber will be providing me with the June 30, 1994 internal financial statements as well as work in process reports and budget information. Dave informs me that the original budget showed revenue projections for 1994 to be approximately \$55,000,000. However, this included the University of California at Davis project which has since folded, and a certain amount of Continental Medical Systems work which has never happened, and a Penn National start to be sometime mid-year 1994. We understand that the project now will not start at best until late 1994.

Due to these lost or delayed opportunities, the estimated revenues for 1994 are now only \$35,000,000. That combined with a poor winter and extremely competitive bidding, CCI has needed to streamline the overhead and make drastic reductions in order to salvage the year.

Due to the slow winter start, CCI will show a small loss at June 30, 1994. Dave Barber and Shane Miller are confident that with the current work on the books, this loss will be reversed by December 31, 1994. They anticipate a break even year or small profit.

We have had recent discussions about the work on hand approaching our capacity. I discussed that issue in detail with Shane, Dave and Doug, and they understand our position clearly. However, we must factor in the Penn National project, which is absorbing \$26,000,000 bond capacity right now, and USF&G has not yet issued a bond on that job. The bond will be required when the construction phase starts, and at this time there are no significant resources or working capital required for this project. I feel that it is appropriate to discount the impact of the Penn National project as we approach our capacity. I will have further discussions with you on that issue as needed.

I trust that this information satisfactorily answers your questions. I feel that several of the responses and measures taken in 1994 truly demonstrate the competence of the CCI management team. The fact that they have extremely timely and accurate information to work with and they are willing to take quick and drastic measures to adjust overhead and react to what the

USFG/BS 0871

REAL ESTATE/CONSTRUCTION

John M. Ortenzio
CCI Construction



AWARD RECIPIENT

After college, when most graduates are looking for a job to start their careers, John M. Ortenzio already knew he wanted to go into business for himself. Working for someone else was just a rung on the ladder of getting to the top on his own.

Ortenzio began as an apprentice carpenter, then worked at a real estate development company where he gained the experience he'd need to go it alone. He founded CCI Construction Co. in 1984. Much of the early work was performed in Florida through a partnership with Rehabilitation Hospital Services

Corp. In the early years, there was a lot of travel involved. Most of CCI's projects were out of state, and Ortenzio was responsible for planning and implementing business administration, contract negotiations, labor relations and on-site project management. In the mid 1980s, the company grew, particularly in the health care industry, and expanded its offices to Florida and California within a span of five years.

As the construction economy has changed over the past five years, so has CCI. Private development of the 1980s has been replaced with public-sector work, and CCI has positioned itself for the marketplace of the 1990s. Flexibility is one of the keys to CCI's success.

CCI Construction is ready to tackle the 1990s with a new strategic plan and restructured management team. CCI redirected its resources to the Pennsylvania market and eventually to Maryland, Virginia and West Virginia, where it had to compete with larger, well-established construction companies. The company also opened an office outside of Washington, D.C. with plans to develop in that area.

Recently, the firm was awarded a major contract to build Penn National Insurance Co.'s headquarters facility in downtown Harrisburg.

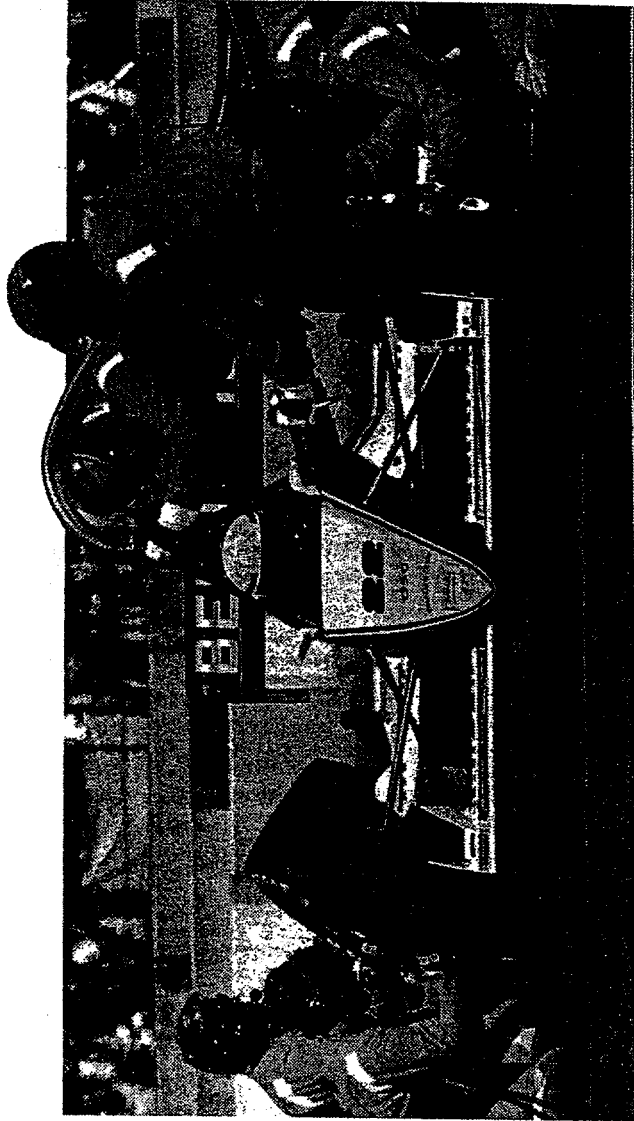
CCI has moved fast and kept on top of a changing economy with careful planning, research and study. It has positioned itself not only for the 1990s, but for the year 2000 and beyond.

VITAL STATISTICS

Nominee: John M. Ortenzio
Title: President
Company: CCI Construction
Business: General contractor/construction manager
Location: Mechanicsburg
Year Established: 1984

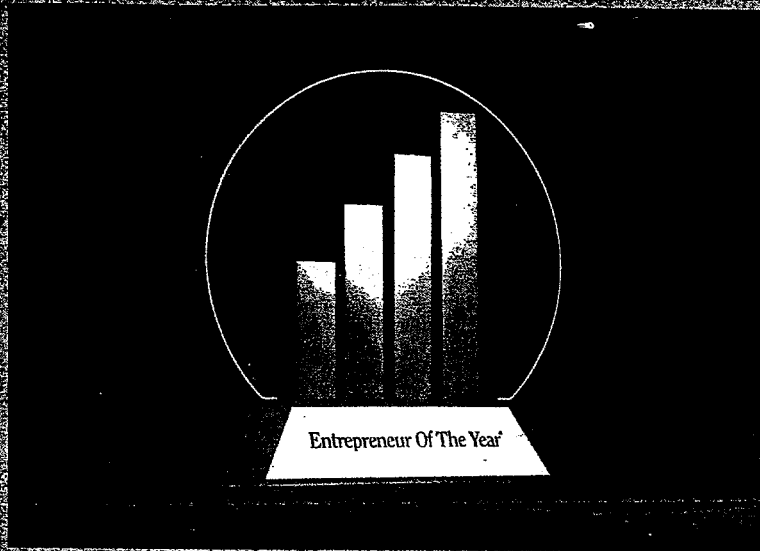
USFG/BS 0860

When pushing the limits of performance,
you need the Ernst & Young team behind you.



ERNST & YOUNG ENTREPRENEURIAL SERVICES
"Our only business is entrepreneurs."

USFG/BS 0861



The 1994 Entrepreneur Of The Year Awards

 ERNST & YOUNG

 IDC

 MERRILL LYNCH

 MCGRAW-HILL

 WPP

USFG/BS 0862



WITH APPRECIATION

Ernst & Young and national co-sponsors Inc. Magazine and Merrill Lynch extend their thanks and appreciation to the distinguished panel of judges whose job it was to select this year's Entrepreneur Of The Year award recipients.

S. Dale High
High Industries, Inc.

Marlin Miller, Jr.
Arrow International, Inc.

Allan S. Noddle
Giant Foods, Inc.

Rocco A. Ortenzio
Continental Medical Systems, Inc.

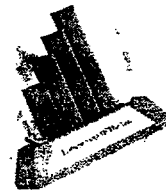
Sandy Solmon
Sweet Street Desserts

Thomas W. Wolf
Wolf Organization

Kenneth L. Wolfe
Hershey Foods Corporation

Joyce S. Zeigler
Technology Council of Central Pennsylvania

USFG/BS 0863



PROGRAM

Thank you for joining us in honoring
Central Pennsylvania's outstanding entrepreneurs.

Reception - 6:00 p.m.

Dinner - 7:00 p.m.

WELCOME AND INTRODUCTIONS

Lester S. Fry, Jr.
Managing Partner Central Pennsylvania Practice
Ernst & Young

Thomas E. Philips
First Vice President - Complex Director
Central Pennsylvania Complex
Merrill Lynch

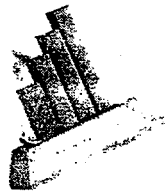
Terry C. Kile
General Manager
WHP 580

AWARDS PRESENTATION

Jeffrey J. Vrabel
Director of Entrepreneurial Services
Central Pennsylvania Practice
Ernst & Young

David A. Schankweiler
Publisher
Central Penn Business Journal

USFG/BS 0864



THE FINALISTS

EMERGING

Rebecca J. Chick
Donald J. Farinelli
Daniel L. Harple, Jr.
Jeffrey L. Kissling

Alternatives in Health Care Management, Inc.
Farinelli Construction Inc.
InSoft, Inc.
Soft Systems Engineering, Inc.

MANUFACTURING

Robert D. Fogal, Sr.
Franklin C. Schoch
James M. Stine
Marlin S. Walmer
Richard Witwer

International Marketing, Inc.
M.G.P., Inc.
Cressona Aluminum Company
Electron Energy Corporation
Kalas Manufacturing, Inc.

CONSTRUCTION

Paul E. Lehman
John M. Ortenzio

Paul E. Lehman, Inc.
CCI Construction Company

SERVICES

Donald C. Donagher, Jr.
Kevin M. Harter
Joseph T. Maurer
Anthony A. Pascotti
Alan D. Todd
Gary R. Seibert

Central Credit Control
Keystone Medical Systems
The Underwriters' Group
ADT Data Systems, Inc.
KidSports International

SOCIALLY RESPONSIBLE

Dawn A. Magaro
Donald F. Mazziotti
Thomas M. McMahon P.E.
Gail Siegel

Access to America, Inc.
Delta Development Group, Inc.
Entech Engineering Inc.
Children's Play Room Inc.



THE FINALISTS

SUPPORTER OF ENTREPRENEURSHIP

Thomas S. Capello
David Benson Carver
Gerald K. Morrison

First Capitol Bank
Y.C.I.D.C.
Buchanan Ingersoll

MINORITY / WOMAN ENTREPRENEUR

Shaun N. Balani
Anne Beller
Trish Greenberg
Janie Robins
Hasu P. Shah
Anil C. Thakrar

Travel Time Travel Agency, Inc.
Auntie Anne's
Movie Merchants
Hersha Enterprises Ltd.
Anil C. Thakrar

RETAIL

Ann Barnett
Stephen Barnett
Wayne Block
Gary W. Croft
Philip R. Wenger

The Kitchen Works
Block Business Systems
Pennsylvania Prescriptions, Inc.
Isaac's Deli, Inc.

TURNAROUND

J. Albert Dame
John D. DeFelice

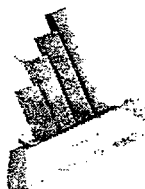
Dame Media, Inc.
Precision Components Corp.

MASTER ENTREPRENEUR

James E. Grandon, Jr.
Donald B. Stabler

Jack Gaughen Realtor
Stabler Companies Inc.

USFG/BS 0866



SPONSORS

ERNST & YOUNG

Ernst & Young Entrepreneurial Services is a nationwide organization of professionals dedicated solely to the service of owner managed businesses. Ernst & Young is the leading international professional services firm with 64,000 people in more than 600 cities in over 100 countries, including 20,000 people in more than 100 U.S. cities.



Inc. is the magazine for growing companies. It is circulated to 2.4 million business owners and managers. Inc. features news of entrepreneurial businesses, management, finance, personnel, marketing, and other issues critical to the business community.



Merrill Lynch

Merrill Lynch Business Financial Services is a leader in providing small and mid-sized businesses with a range of comprehensive, efficient and convenient investment, financing and employee benefit services throughout the business life cycle. Merrill Lynch currently provides services to more than 450,000 business owners, through 11,000 Financial Consultants in over 450 offices nationwide.

CENTRAL-PENN BUSINESS JOURNAL

CENTRAL PENN BUSINESS JOURNAL is a bi-weekly newspaper read by more than 50,000 business owners, managers and executives. It covers commerce news in the Harrisburg, Lancaster and York metropolitan areas, and also provides readers with insights into specific industry topics, ranging from health care to business and the environment, through its Inside Business section.

WHP580

WHP 580 provides a full News, Information, Entertainment and Service package to the population reached by its powerful signal in Central Pennsylvania. WHP 580 provides a full-time coverage of special events. Programming includes stimulating talk shows, where people of diverse views and ages turn to discuss any topic, with all types of opinions welcomed.

USFG/BS 0867



BANQUET/PATRONS

AMP

Still thriving on the entrepreneurial spirit in which it was founded more than 50 years ago, AMP today is the world's supplier-of-choice for complete interconnection systems, products and services. Meeting the electronic, optical, electrical, and business requirements of industry worldwide, from locations in 36 nations, AMP delivers local attention and world-class service around the globe. 1993 sales \$3.45 billion, employment 27,200.

Buchanan Ingersoll PROFESSIONAL CORPORATION

Buchanan Ingersoll ranks among the oldest, most experienced law firms in the mid-Atlantic region. As one of the few state-wide firms with an established Central Pennsylvania practice, our Harrisburg office is comprised of experienced attorneys with roots in the legal, business and governmental communities. The firm has additional offices in Philadelphia, Pittsburgh, Miami, Tampa, Princeton and Lexington.



Capital BlueCross Pennsylvania BlueShield

Independent Licensees of the
Blue Cross and Blue Shield Association

Capital Blue Cross and Pennsylvania Blue Shield provide health insurance coverage for businesses, families and individuals throughout central Pennsylvania. Working in partnership and through their subsidiaries, the companies offer a wide range of health benefit options - from traditional health insurance to managed care options and third-party administrative services. Serving subscriber needs since the 1930's, the companies continue as recognized leaders in the health insurance industry.

Edison VENTURE FUND

Edison Venture Fund provides financing and guidance to growing companies in the Midatlantic Region through offices in Harrisburg, Lawrenceville, NJ and Washington, DC. Edison seeks promising enterprises with unique products, services and market opportunities. Edison has invested in 50 companies, including 15 companies in Pennsylvania. Edison's capital pool exceeds \$150 million, with an average initial investment of about \$2 million.

(Patrons continued on back page)

USFG/BS 0868



BANQUET PATRONS

Hershey Foods Corporation

Hershey Foods Corporation, a leading North American producer of chocolate, confectionery and pasta products, is celebrating its 100th anniversary this year! For a century, Hershey Foods Corporation has produced great-tasting products that have become American traditions.



**TECHNOLOGY
COUNCIL
OF CENTRAL
PENNSYLVANIA**

The Technology Council of Central Pennsylvania is a division of Eastern Technology Council - a 750-member networking association whose members include technology-driven companies and organizations. Members have access to over 100 free technology briefings, telecommunications discounts, venture capital funds, mentoring programs, as well as several other entrepreneurial services that encourage business relationships which in turn help grow the region's economic base.

ACKNOWLEDGMENT:

*Preproduction video services underwritten by PHICO Video Center.
Awards Banquet floral designs underwritten by Royer's Flowers.*

USFG/BS 0869

22

COPYRIGHT © 2002, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

AU Section 230

Due Professional Care in the Performance of Work fn *(1)

Source: SAS No. 1, section 230; SAS No. 41; SAS No. 82.

Issue date, unless otherwise indicated: November, 1972.

.01 The third general standard is:

Due professional care is to be exercised in the planning and performance of the audit and the preparation of the report. fn 1(2)

[As amended, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

.02 This standard requires the independent auditor to plan and perform his or her work with due professional care. Due professional care imposes a responsibility upon each professional within an independent auditor's organization to observe the standards of field work and reporting. [As amended, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

.03 *Cooley on Torts*, a legal treatise, describes the obligation for due care as follows:

Every man who offers his services to another and is employed assumes the duty to exercise in the employment such skill as he possesses with reasonable care and diligence. In all these employments where peculiar skill is requisite, if one offers his services, he is understood as holding himself out to the public as possessing the degree of skill commonly possessed by others in the same employment, and if his pretensions are unfounded, he commits a species of fraud upon every man who employs him in reliance on his public profession. But no man, whether skilled or unskilled, undertakes that the task he assumes shall be performed successfully, and without fault or error; he undertakes for good faith and integrity, but not for infallibility, and he is liable to his employer for negligence, bad faith, or dishonesty, but not for losses consequent upon pure errors of judgment. fn 2(3)

[As amended, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

COPYRIGHT © 2002, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

- .04 The matter of due professional care concerns what the independent auditor does and how well he or she does it. The quotation from *Cooley on Torts* provides a source from which an auditor's responsibility for conducting an audit with due professional care can be derived. The remainder of the section discusses the auditor's responsibility in the context of an audit. [As amended, April 1982, by Statement on Auditing Standards No. 41 (see section 339). As amended, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]
- .05 An auditor should possess "the degree of skill commonly possessed" by other auditors and should exercise it with "reasonable care and diligence" (that is, with due professional care). [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]
- .06 Auditors should be assigned to tasks and supervised commensurate with their level of knowledge, skill, and ability so that they can evaluate the audit evidence they are examining. The auditor with final responsibility for the engagement should know, at a minimum, the relevant professional accounting and auditing standards and should be knowledgeable about the client. fn 3(4) The auditor with final responsibility is responsible for the assignment of tasks to, and supervision of, assistants. fn 4(5) [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

Professional Skepticism

- .07 Due professional care requires the auditor to exercise *professional skepticism*. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. The auditor uses the knowledge, skill, and ability called for by the profession of public accounting to diligently perform, in good faith and with integrity, the gathering and objective evaluation of evidence. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]
- .08 Gathering and objectively evaluating audit evidence requires the auditor to consider the competency and sufficiency of the evidence. Since evidence is gathered and evaluated throughout the audit, professional skepticism should be exercised throughout the audit process. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

COPYRIGHT © 2002, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

- .09 The auditor neither assumes that management is dishonest nor assumes unquestioned honesty. In exercising professional skepticism, the auditor should not be satisfied with less than persuasive evidence because of a belief that management is honest. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

Reasonable Assurance

- .10 The exercise of due professional care allows the auditor to obtain reasonable assurance that the financial statements are free of material misstatement, whether caused by error or fraud. Absolute assurance is not attainable because of the nature of audit evidence and the characteristics of fraud. Therefore, an audit conducted in accordance with generally accepted auditing standards may not detect a material misstatement. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]
- .11 The independent auditor's objective is to obtain sufficient competent evidential matter to provide him or her with a reasonable basis for forming an opinion. The nature of most evidence derives, in part, from the concept of selective testing of the data being audited, which involves judgment regarding both the areas to be tested and the nature, timing, and extent of the tests to be performed. In addition, judgment is required in interpreting the results of audit testing and evaluating audit evidence. Even with good faith and integrity, mistakes and errors in judgment can be made. Furthermore, accounting presentations contain accounting estimates, the measurement of which is inherently uncertain and depends on the outcome of future events. The auditor exercises professional judgment in evaluating the reasonableness of accounting estimates based on information that could reasonably be expected to be available prior to the completion of field work. fn 5(6) As a result of these factors, in the great majority of cases, the auditor has to rely on evidence that is persuasive rather than convincing. fn 6(7) [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]
- .12 Because of the characteristics of fraud, particularly those involving concealment and falsified documentation (including forgery), a properly planned and performed audit may not detect a material misstatement. For example, an audit conducted in accordance with generally accepted auditing standards rarely involves authentication of documentation, nor are auditors trained as or expected to be experts in such authentication. Also, auditing procedures may be ineffective for detecting an intentional misstatement that is concealed through collusion among client personnel and third parties or among management or

COPYRIGHT © 2002, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

employees of the client. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

- .13 Since the auditor's opinion on the financial statements is based on the concept of obtaining reasonable assurance, the auditor is not an insurer and his or her report does not constitute a guarantee. Therefore, the subsequent discovery that a material misstatement, whether from error or fraud, exists in the financial statements does not, in and of itself, evidence (a) failure to obtain reasonable assurance, (b) inadequate planning, performance, or judgment, (c) the absence of due professional care, or (d) a failure to comply with generally accepted auditing standards. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

COPYRIGHT © 2002, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

Endnotes

1 (Popup - Footnote)

* [Title amended, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

2 (Popup - Footnote)

1 This amendment revises the third general standard of the ten generally accepted auditing standards. [Footnote added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

3 (Popup - Footnote)

2 D. Haggard, *Cooley on Torts*, 472 (4th ed., 1932). [Footnote added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

4 (Popup - Footnote)

3 See section 311, *Planning and Supervision*, paragraph .07. [Footnote added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

5 (Popup - Footnote)

4 See section 311.11. [Footnote added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

6 (Popup - Footnote)

5 See section 342, *Auditing Accounting Estimates*. [Footnote added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

7 (Popup - Footnote)

6 See section 326, *Evidential Matter*. [Footnote added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

20

COPYRIGHT © 2002, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

AU Section 311

Planning and Supervision

Source: SAS No. 22; SAS No. 47; SAS No. 48; SAS No. 77.

See section 9311 for interpretations of this section.

Effective for periods ending after September 30, 1978, unless otherwise indicated.

- .01 The first standard of field work requires that "the work is to be adequately planned and assistants, if any, are to be properly supervised." This section provides guidance to the independent auditor conducting an audit in accordance with generally accepted auditing standards on the considerations and procedures applicable to planning and supervision, including preparing an audit program, obtaining knowledge of the entity's business, and dealing with differences of opinion among firm personnel. Planning and supervision continue throughout the audit, and the related procedures frequently overlap.
- .02 The auditor with final responsibility for the audit may delegate portions of the planning and supervision of the audit to other firm personnel. For purposes of this section, (a) firm personnel other than the auditor with final responsibility for the audit are referred to as *assistants* and (b) the term *auditor* refers to either the auditor with final responsibility for the audit or assistants.

Planning

- .03 Audit planning involves developing an overall strategy for the expected conduct and scope of the audit. The nature, extent, and timing of planning vary with the size and complexity of the entity, experience with the entity, and knowledge of the entity's business. In planning the audit, the auditor should consider, among other matters:
- a. Matters relating to the entity's business and the industry in which it operates (see paragraph .07).
 - b. The entity's accounting policies and procedures.
 - c. The methods used by the entity to process significant accounting information (see paragraph .09), including the use of service organizations, such as outside service

COPYRIGHT © 2002, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

centers.

- d.* Planned assessed level of control risk. (See section 319.)
- e.* Preliminary judgment about materiality levels for audit purposes.
- f.* Financial statement items likely to require adjustment.
- g.* Conditions that may require extension or modification of audit tests, such as the risk of material error or fraud or the existence of related party transactions.
- h.* The nature of reports expected to be rendered (for example, a report on consolidated or consolidating financial statements, reports on financial statements filed with the SEC, or special reports such as those on compliance with contractual provisions).

[As amended, December, 1983, by Statement on Auditing Standards No. 47.] (See section 312.14.) [As amended, effective for periods beginning after August 31, 1984, by Statement on Auditing Standards No. 48.]

.04 Procedures that an auditor may consider in planning the audit usually involve review of his records relating to the entity and discussion with other firm personnel and personnel of the entity. Examples of those procedures include:

- a.* Reviewing correspondence files, prior year's working papers, permanent files, financial statements, and auditor's reports.
- b.* Discussing matters that may affect the audit with firm personnel responsible for non-audit services to the entity.
- c.* Inquiring about current business developments affecting the entity.
- d.* Reading the current year's interim financial statements.
- e.* Discussing the type, scope, and timing of the audit with management of the entity, the board of directors, or its audit committee.
- f.* Considering the effects of applicable accounting and auditing pronouncements, particularly new ones.
- g.* Coordinating the assistance of entity personnel in data preparation.
- h.* Determining the extent of involvement, if any, of consultants, specialists, and

COPYRIGHT © 2002, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

internal auditors.

- i.* Establishing the timing of the audit work.
- j.* Establishing and coordinating staffing requirements.

The auditor may wish to prepare a memorandum setting forth the preliminary audit plan, particularly for large and complex entities.

- .05 In planning the audit, the auditor should consider the nature, extent, and timing of work to be performed and should prepare a written audit program (or set of written audit programs) for every audit. The audit program should set forth in reasonable detail the audit procedures that the auditor believes are necessary to accomplish the objectives of the audit. The form of the audit program and the extent of its detail will vary with the circumstances. In developing the program, the auditor should be guided by the results of the planning considerations and procedures. As the audit progresses, changed conditions may make it necessary to modify planned audit procedures. [As amended, effective for engagements beginning after December 15, 1995, by Statement on Auditing Standards No. 77.]
- .06 The auditor should obtain a level of knowledge of the entity's business that will enable him to plan and perform his audit in accordance with generally accepted auditing standards. That level of knowledge should enable him to obtain an understanding of the events, transactions, and practices that, in his judgment, may have a significant effect on the financial statements. The level of knowledge customarily possessed by management relating to managing the entity's business is substantially greater than that which is obtained by the auditor in performing his audit. Knowledge of the entity's business helps the auditor in:
 - a.* Identifying areas that may need special consideration.
 - b.* Assessing conditions under which accounting data are produced, processed, reviewed, and accumulated within the organization.
 - c.* Evaluating the reasonableness of estimates, such as valuation of inventories, depreciation, allowances for doubtful accounts, and percentage of completion of long-term contracts.
 - d.* Evaluating the reasonableness of management representations.
 - e.* Making judgments about the appropriateness of the accounting principles applied

COPYRIGHT © 2002, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

and the adequacy of disclosures. [fn 1](1)

- .07 The auditor should obtain a knowledge of matters that relate to the nature of the entity's business, its organization, and its operating characteristics. Such matters include, for example, the type of business, types of products and services, capital structure, related parties, locations, and production, distribution, and compensation methods. The auditor should also consider matters affecting the industry in which the entity operates, such as economic conditions, government regulations, and changes in technology, as they relate to his audit. Other matters, such as accounting practices common to the industry, competitive conditions, and, if available, financial trends and ratios should also be considered by the auditor.
- .08 Knowledge of an entity's business is ordinarily obtained through experience with the entity or its industry and inquiry of personnel of the entity. Working papers from prior years may contain useful information about the nature of the business, organizational structure, operating characteristics, and transactions that may require special consideration. Other sources an auditor may consult include AICPA accounting and audit guides, industry publications, financial statements of other entities in the industry, textbooks, periodicals, and individuals knowledgeable about the industry.
- .09 The auditor should consider the methods the entity uses to process accounting information in planning the audit because such methods influence the design of the internal control. The extent to which computer processing is used in significant accounting applications, fn 2(2) as well as the complexity of that processing, may also influence the nature, timing, and extent of audit procedures. Accordingly, in evaluating the effect of an entity's computer processing on an audit of financial statements, the auditor should consider matters such as—
- a. The extent to which the computer is used in each significant accounting application.
 - b. The complexity of the entity's computer operations, including the use of an outside service center. fn 3(3)
 - c. The organizational structure of the computer processing activities.
 - d. The availability of data. Documents that are used to enter information into the computer for processing, certain computer files, and other evidential matter that may be required by the auditor may exist only for a short period or only in computer-readable form. In some computer systems, input documents may not exist at all because information is directly entered into the system. An entity's data

COPYRIGHT © 2002, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

retention policies may require the auditor to request retention of some information for his review or to perform audit procedures at a time when the information is available. In addition, certain information generated by the computer for management's internal purposes may be useful in performing substantive tests (particularly analytical procedures). fn 4(4)

- e. The use of computer-assisted audit techniques to increase the efficiency of performing audit procedures. [fn 5](5) Using computer-assisted audit techniques may also provide the auditor with an opportunity to apply certain procedures to an entire population of accounts or transactions. In addition, in some accounting systems, it may be difficult or impossible for the auditor to analyze certain data or test specific control procedures without computer assistance.

[Paragraph added, effective for periods beginning after August 31, 1984, by Statement on Auditing Standards No. 48.]

- .10 The auditor should consider whether specialized skills are needed to consider the effect of computer processing on the audit, to understand the controls, or to design and perform audit procedures. If specialized skills are needed, the auditor should seek the assistance of a professional possessing such skills, who may be either on the auditor's staff or an outside professional. If the use of such a professional is planned, the auditor should have sufficient computer-related knowledge to communicate the objectives of the other professional's work; to evaluate whether the specified procedures will meet the auditor's objectives; and to evaluate the results of the procedures applied as they relate to the nature, timing, and extent of other planned audit procedures. The auditor's responsibilities with respect to using such a professional are equivalent to those for other assistants. fn 6(6) [Paragraph added, effective for periods beginning after August 31, 1984, by Statement on Auditing Standards No. 48.]

Supervision

- .11 Supervision involves directing the efforts of assistants who are involved in accomplishing the objectives of the audit and determining whether those objectives were accomplished. Elements of supervision include instructing assistants, keeping informed of significant problems encountered, reviewing the work performed, and dealing with differences of opinion among firm personnel. The extent of supervision appropriate in a given instance depends on many factors, including the complexity of the subject matter and the qualifications of persons performing the work. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 48, July 1984.]

COPYRIGHT © 2002, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

- .12 Assistants should be informed of their responsibilities and the objectives of the procedures that they are to perform. They should be informed of matters that may affect the nature, extent, and timing of procedures they are to perform, such as the nature of the entity's business as it relates to their assignments and possible accounting and auditing problems. The auditor with final responsibility for the audit should direct assistants to bring to his attention significant accounting and auditing questions raised during the audit so that he may assess their significance. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 48, July 1984.]
- .13 The work performed by each assistant should be reviewed to determine whether it was adequately performed and to evaluate whether the results are consistent with the conclusions to be presented in the auditor's report. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 48, July 1984.]
- .14 The auditor with final responsibility for the audit and assistants should be aware of the procedures to be followed when differences of opinion concerning accounting and auditing issues exist among firm personnel involved in the audit. Such procedures should enable an assistant to document his disagreement with the conclusions reached if, after appropriate consultation, he believes it necessary to disassociate himself from the resolution of the matter. In this situation, the basis for the final resolution should also be documented. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 48, July 1984.]

Effective Date

- .15 Statements on Auditing Standards generally are effective at the time of their issuance. However, since this section provides for practices that may differ in certain respects from practices heretofore considered acceptable, this section will be effective for audits made in accordance with generally accepted auditing standards for periods ending after September 30, 1978. [Formerly paragraph .13, number changed by issuance of Statement on Auditing Standards No. 48, effective for periods beginning after August 31, 1984.]

AU Section 312

Audit Risk and Materiality in Conducting an Audit ^{*(7)}

Source: SAS No. 47; SAS No. 82; SAS No. 96.

COPYRIGHT © 2002, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

See section 9312 for interpretations of this section.

Effective for audits of financial statements for periods beginning after June 30, 1984, unless otherwise indicated.

- .01 This section provides guidance on the auditor's consideration of audit risk and materiality when planning and performing an audit of financial statements in accordance with generally accepted auditing standards. Audit risk and materiality affect the application of generally accepted auditing standards, especially the standards of field work and reporting, and are reflected in the auditor's standard report. Audit risk and materiality, among other matters, need to be considered together in determining the nature, timing, and extent of auditing procedures and in evaluating the results of those procedures.
- .02 The existence of audit risk is recognized in the description of the responsibilities and functions of the independent auditor that states, "Because of the nature of audit evidence and the characteristics of fraud, the auditor is able to obtain reasonable, but not absolute, assurance that material misstatements are detected." fn 1(8) Audit risk fn 2(9) is the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated. fn 3(10) [As amended, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]
- .03 The concept of materiality recognizes that some matters, either individually or in the aggregate, are important for fair presentation of financial statements in conformity with generally accepted accounting principles, fn 4(11) while other matters are not important. The representation in the auditor's standard report regarding fair presentation, in all material respects, in conformity with generally accepted accounting principles indicates the auditor's belief that the financial statements taken as a whole are not materially misstated. [As amended, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82. Revised, October 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.]
- .04 Financial statements are materially misstated when they contain misstatements whose effect, individually or in the aggregate, is important enough to cause them not to be presented fairly, in all material respects, in conformity with generally accepted accounting principles. Misstatements can result from errors or fraud. fn 5(12) [As amended, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

COPYRIGHT © 2002, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

- .05 In planning the audit, the auditor is concerned with matters that could be material to the financial statements. The auditor has no responsibility to plan and perform the audit to obtain reasonable assurance that misstatements, whether caused by errors or fraud, that are not material to the financial statements are detected. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]
- .06 The term *errors* refers to unintentional misstatements or omissions of amounts or disclosures in financial statements. Errors may involve—
- Mistakes in gathering or processing data from which financial statements are prepared.
 - Unreasonable accounting estimates arising from oversight or misinterpretation of facts.
 - Mistakes in the application of accounting principles relating to amount, classification, manner of presentation, or disclosure. fn 6(13)
- [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]
- .07 Although *fraud* is a broad legal concept, the auditor's interest specifically relates to fraudulent acts that cause a misstatement of financial statements. Two types of misstatements are relevant to the auditor's consideration in a financial statement audit—misstatements arising from fraudulent financial reporting and misstatements arising from misappropriation of assets. These two types of misstatements are further described in section 316, *Consideration of Fraud in a Financial Statement Audit*. The primary factor that distinguishes fraud from error is whether the underlying action that results in the misstatement in financial statements is intentional or unintentional. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]
- .08 When considering the auditor's responsibility to obtain reasonable assurance that the financial statements are free from material misstatement, there is no important distinction between errors and fraud. There is a distinction, however, in the auditor's response to detected misstatements. Generally, an isolated, immaterial error in processing accounting data or applying accounting principles is not significant to the audit. In contrast, when fraud is detected, the auditor should consider the implications for the integrity of management or employees and the possible effect on other aspects of the audit. [Paragraph added, effective for audits of financial statements for periods ending on or

COPYRIGHT © 2002, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

after December 15, 1997, by Statement on Auditing Standards No. 82.]

- .09 When concluding as to whether the effect of misstatements, individually or in the aggregate, is material, an auditor ordinarily should consider their nature and amount in relation to the nature and amount of items in the financial statements under audit. For example, an amount that is material to the financial statements of one entity may not be material to the financial statements of another entity of a different size or nature. Also, what is material to the financial statements of a particular entity might change from one period to another. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]
- .10 The auditor's consideration of materiality is a matter of professional judgment and is influenced by his or her perception of the needs of a reasonable person who will rely on the financial statements. The perceived needs of a reasonable person are recognized in the discussion of materiality in Financial Accounting Standards Board Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information*, which defines materiality as "the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement." That discussion recognizes that materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]
- .11 As a result of the interaction of quantitative and qualitative considerations in materiality judgments, misstatements of relatively small amounts that come to the auditor's attention could have a material effect on the financial statements. For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue. fn 7(14)
[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]

Planning the Audit

- .12 The auditor should consider audit risk and materiality both in (a) planning the audit and designing auditing procedures and (b) evaluating whether the financial statements taken as a whole are presented fairly, in all material respects, in conformity with generally accepted accounting principles. The auditor should consider audit risk and materiality in the first circumstance to obtain sufficient competent evidential matter on which to properly

COPYRIGHT © 2002, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

evaluate the financial statements in the second circumstance. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]

Considerations at the Financial Statements Level [fn 8](15)

- .13 The auditor should plan the audit so that audit risk will be limited to a low level that is, in his or her professional judgment, appropriate for expressing an opinion on the financial statements. Audit risk may be assessed in quantitative or nonquantitative terms. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]

- .14 Section 311, *Planning and Supervision*, requires the auditor, in planning the audit, to take into consideration, among other matters, his or her preliminary judgment about materiality levels for audit purposes. fn 9(16) That judgment may or may not be quantified. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]

- .15 According to section 311, the nature, timing, and extent of planning and thus of the considerations of audit risk and materiality vary with the size and complexity of the entity, the auditor's experience with the entity, and his or her knowledge of the entity's business. Certain entity-related factors also affect the nature, timing, and extent of auditing procedures with respect to specific account balances and classes of transactions and related assertions. (See paragraphs .24 through .33.) [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]

- .16 An assessment of the risk of material misstatement (whether caused by error or fraud) should be made during planning. The auditor's understanding of internal control may heighten or mitigate the auditor's concern about the risk of material misstatement. fn 10(17) In considering audit risk, the auditor should specifically assess the risk of material misstatement of the financial statements due to fraud. fn 11(18) The auditor should consider the effect of these assessments on the overall audit strategy and the expected conduct and scope of the audit. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

- .17 Whenever the auditor has concluded that there is significant risk of material misstatement of the financial statements, the auditor should consider this conclusion in determining the nature, timing, or extent of procedures; assigning staff; or requiring appropriate levels of supervision. The knowledge, skill, and ability of personnel assigned significant engagement

COPYRIGHT © 2002, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

responsibilities should be commensurate with the auditor's assessment of the level of risk for the engagement. Ordinarily, higher risk requires more experienced personnel or more extensive supervision by the auditor with final responsibility for the engagement during both the planning and the conduct of the engagement. Higher risk may cause the auditor to expand the extent of procedures applied, apply procedures closer to or as of year end, particularly in critical audit areas, or modify the nature of procedures to obtain more persuasive evidence. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

- .18 In an audit of an entity with operations in multiple locations or components, the auditor should consider the extent to which auditing procedures should be performed at selected locations or components. The factors an auditor should consider regarding the selection of a particular location or component include (a) the nature and amount of assets and transactions executed at the location or component, (b) the degree of centralization of records or information processing, (c) the effectiveness of the control environment, particularly with respect to management's direct control over the exercise of authority delegated to others and its ability to effectively supervise activities at the location or component, (d) the frequency, timing, and scope of monitoring activities by the entity or others at the location or component, and (e) judgments about materiality of the location or component. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]
- .19 In planning the audit, the auditor should use his or her judgment as to the appropriately low level of audit risk and his or her preliminary judgment about materiality levels in a manner that can be expected to provide, within the inherent limitations of the auditing process, sufficient evidential matter to obtain reasonable assurance about whether the financial statements are free of material misstatement. Materiality levels include an overall level for each statement; however, because the statements are interrelated, and for reasons of efficiency, the auditor ordinarily considers materiality for planning purposes in terms of the smallest aggregate level of misstatements that could be considered material to any one of the financial statements. For example, if the auditor believes that misstatements aggregating approximately \$100,000 would have a material effect on income but that such misstatements would have to aggregate approximately \$200,000 to materially affect financial position, it would not be appropriate for him or her to design auditing procedures that would be expected to detect misstatements only if they aggregate approximately \$200,000. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]
- .20 The auditor plans the audit to obtain reasonable assurance of detecting misstatements that

COPYRIGHT © 2002, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

he or she believes could be large enough, individually or in the aggregate, to be quantitatively material to the financial statements. Although the auditor should be alert for misstatements that could be qualitatively material, it ordinarily is not practical to design procedures to detect them. Section 326, *Evidential Matter*, states that "an auditor typically works within economic limits; his or her opinion, to be economically useful, must be formed within a reasonable length of time and at reasonable cost." [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]

- .21 In some situations, the auditor considers materiality for planning purposes before the financial statements to be audited are prepared. In other situations, planning takes place after the financial statements under audit have been prepared, but the auditor may be aware that they require significant modification. In both types of situations, the auditor's preliminary judgment about materiality might be based on the entity's annualized interim financial statements or financial statements of one or more prior annual periods, as long as recognition is given to the effects of major changes in the entity's circumstances (for example, a significant merger) and relevant changes in the economy as a whole or the industry in which the entity operates. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]
- .22 Assuming, theoretically, that the auditor's judgment about materiality at the planning stage was based on the same information available at the evaluation stage, materiality for planning and evaluation purposes would be the same. However, it ordinarily is not feasible for the auditor, when planning an audit, to anticipate all of the circumstances that may ultimately influence judgments about materiality in evaluating the audit findings at the completion of the audit. Thus, the auditor's preliminary judgment about materiality ordinarily will differ from the judgment about materiality used in evaluating the audit findings. If significantly lower materiality levels become appropriate in evaluating audit findings, the auditor should re-evaluate the sufficiency of the auditing procedures he or she has performed. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]
- .23 In planning auditing procedures, the auditor should also consider the nature, cause (if known), and amount of misstatements that he or she is aware of from the audit of the prior period's financial statements. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]

Considerations at the Individual Account-Balance or Class-of-Transactions Level

- .24 The auditor recognizes that there is an inverse relationship between audit risk and

COPYRIGHT © 2002, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

materiality considerations. For example, the risk that a particular account balance or class of transactions and related assertions could be misstated by an extremely large amount might be very low, but the risk that it could be misstated by an extremely small amount might be very high. Holding other planning considerations equal, either a decrease in the level of audit risk that the auditor judges to be appropriate in an account balance or a class of transactions or a decrease in the amount of misstatements in the balance or class that the auditor believes could be material would require the auditor to do one or more of the following: (a) select a more effective auditing procedure, (b) perform auditing procedures closer to year end, or (c) increase the extent of a particular auditing procedure. [Paragraph renumbered and amended, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

- .25** In determining the nature, timing, and extent of auditing procedures to be applied to a specific account balance or class of transactions, the auditor should design procedures to obtain reasonable assurance of detecting misstatements that he or she believes, based on the preliminary judgment about materiality, could be material, when aggregated with misstatements in other balances or classes, to the financial statements taken as a whole. Auditors use various methods to design procedures to detect such misstatements. In some cases, auditors explicitly estimate, for planning purposes, the maximum amount of misstatements in the balance or class that, when combined with misstatements in other balances or classes, could exist without causing the financial statements to be materially misstated. In other cases, auditors relate their preliminary judgment about materiality to a specific account balance or class of transactions without explicitly estimating such misstatements. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]
- .26** The auditor needs to consider audit risk at the individual account-balance or class-of-transactions level because such consideration directly assists in determining the scope of auditing procedures for the balance or class and related assertions. The auditor should seek to restrict audit risk at the individual balance or class level in such a way that will enable him or her, at the completion of the audit, to express an opinion on the financial statements taken as a whole at an appropriately low level of audit risk. Auditors use various approaches to accomplish that objective. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]
- .27** At the account-balance or class-of-transactions level, audit risk consists of (a) the risk (consisting of inherent risk and control risk) that the balance or class and related assertions contain misstatements (whether caused by error or fraud) that could be material to the financial statements when aggregated with misstatements in other balances or classes and (b) the risk (detection risk) that the auditor will not detect such misstatements. The

COPYRIGHT © 2002, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

discussion that follows describes audit risk in terms of three component risks. fn 12(19)
The way the auditor considers these component risks and combines them involves professional judgment and depends on the audit approach.

- a. Inherent risk* is the susceptibility of an assertion to a material misstatement, assuming that there are no related controls. The risk of such misstatement is greater for some assertions and related balances or classes than for others. For example, complex calculations are more likely to be misstated than simple calculations. Cash is more susceptible to theft than an inventory of coal. Accounts consisting of amounts derived from accounting estimates pose greater risks than do accounts consisting of relatively routine, factual data. External factors also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement. In addition to those factors that are peculiar to a specific assertion for an account balance or a class of transactions, factors that relate to several or all of the balances or classes may influence the inherent risk related to an assertion for a specific balance or class. These latter factors include, for example, a lack of sufficient working capital to continue operations or a declining industry characterized by a large number of business failures.
- b. Control risk* is the risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by the entity's internal control. That risk is a function of the effectiveness of the design and operation of internal control in achieving the entity's objectives relevant to preparation of the entity's financial statements. Some control risk will always exist because of the inherent limitations of internal control.
- c. Detection risk* is the risk that the auditor will not detect a material misstatement that exists in an assertion. Detection risk is a function of the effectiveness of an auditing procedure and of its application by the auditor. It arises partly from uncertainties that exist when the auditor does not examine 100 percent of an account balance or a class of transactions and partly because of other uncertainties that exist even if he or she were to examine 100 percent of the balance or class. Such other uncertainties arise because an auditor might select an inappropriate auditing procedure, misapply an appropriate procedure, or misinterpret the audit results. These other uncertainties can be reduced to a negligible level through adequate planning and supervision and conduct of a firm's audit practice in accordance with appropriate quality control standards.

[Paragraph renumbered and amended, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No.

COPYRIGHT © 2002, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

82.]

- .28** Inherent risk and control risk differ from detection risk in that they exist independently of the audit of financial statements, whereas detection risk relates to the auditor's procedures and can be changed at his or her discretion. Detection risk should bear an inverse relationship to inherent and control risk. The less the inherent and control risk the auditor believes exists, the greater the detection risk that can be accepted. Conversely, the greater the inherent and control risk the auditor believes exists, the less the detection risk that can be accepted. These components of audit risk may be assessed in quantitative terms such as percentages or in nonquantitative terms that range, for example, from a minimum to a maximum. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]
- .29** When the auditor assesses inherent risk for an assertion related to an account balance or a class of transactions, he or she evaluates numerous factors that involve professional judgment. In doing so, the auditor considers not only factors peculiar to the related assertion, but also, other factors pervasive to the financial statements taken as a whole that may also influence inherent risk related to the assertion. If an auditor concludes that the effort required to assess inherent risk for an assertion would exceed the potential reduction in the extent of auditing procedures derived from such an assessment, the auditor should assess inherent risk as being at the maximum when designing auditing procedures. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]
- .30** The auditor also uses professional judgment in assessing control risk for an assertion related to the account balance or class of transactions. The auditor's assessment of control risk is based on the sufficiency of evidential matter obtained to support the effectiveness of internal control in preventing or detecting misstatements in financial statement assertions. If the auditor believes controls are unlikely to pertain to an assertion or are unlikely to be effective, or believes that evaluating their effectiveness would be inefficient, he or she would assess control risk for that assertion at the maximum. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]
- .31** The auditor might make separate or combined assessments of inherent risk and control risk. If the auditor considers inherent risk or control risk, separately or in combination, to be less than the maximum, he or she should have an appropriate basis for these assessments. This basis may be obtained, for example, through the use of questionnaires, checklists, instructions, or similar generalized materials and, in the case of control risk, the understanding of internal control and the performance of suitable tests of controls.

COPYRIGHT © 2002, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

However, professional judgment is required in interpreting, adapting, or expanding such generalized material as appropriate in the circumstances. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]

.32 The detection risk that the auditor can accept in the design of auditing procedures is based on the level to which he or she seeks to restrict audit risk related to the account balance or class of transactions and on the assessment of inherent and control risks. As the auditor's assessment of inherent risk and control risk decreases, the detection risk that can be accepted increases. It is not appropriate, however, for an auditor to rely completely on assessments of inherent risk and control risk to the exclusion of performing substantive tests of account balances and classes of transactions where misstatements could exist that might be material when aggregated with misstatements in other balances or classes. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]

.33 An audit of financial statements is a cumulative process; as the auditor performs planned auditing procedures, the evidence obtained may cause him or her to modify the nature, timing, and extent of other planned procedures. As a result of performing auditing procedures or from other sources during the audit, information may come to the auditor's attention that differs significantly from the information on which the audit plan was based. For example, the extent of misstatements detected may alter the judgment about the levels of inherent and control risks, and other information obtained about the financial statements may alter the preliminary judgment about materiality. In such cases, the auditor may need to re-evaluate the auditing procedures he or she plans to apply, based on the revised consideration of audit risk and materiality for all or certain of the account balances or classes of transactions and related assertions. [Paragraph renumbered and amended, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

Evaluating Audit Findings

.34 In evaluating whether the financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, the auditor should aggregate misstatements that the entity has not corrected in a way that enables him or her to consider whether, in relation to individual amounts, subtotals, or totals in the financial statements, they materially misstate the financial statements taken as a whole. Qualitative considerations also influence the auditor in reaching a conclusion as to whether misstatements are material. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]

COPYRIGHT © 2002, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

- .35** The aggregation of misstatements should include the auditor's best estimate of the total misstatements in the account balances or classes of transactions that he or she has examined (hereafter referred to as likely misstatement (20)fn 13), not just the amount of misstatements specifically identified (hereafter referred to as known misstatement). fn 14(21) When the auditor tests an account balance or a class of transactions and related assertions by an analytical procedure, he or she ordinarily would not specifically identify misstatements but would only obtain an indication of whether misstatement might exist in the balance or class and possibly its approximate magnitude. If the analytical procedure indicates that a misstatement might exist, but not its approximate amount, the auditor ordinarily would have to employ other procedures to enable him or her to estimate the likely misstatement in the balance or class. When an auditor uses audit sampling to test an assertion for an account balance or a class of transactions, he or she projects the amount of known misstatements identified in the sample to the items in the balance or class from which the sample was selected. That projected misstatement, along with the results of other substantive tests, contributes to the auditor's assessment of likely misstatement in the balance or class. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]
- .36** The risk of material misstatement of the financial statements is generally greater when account balances and classes of transactions include accounting estimates rather than essentially factual data because of the inherent subjectivity in estimating future events. Estimates, such as those for inventory obsolescence, uncollectible receivables, and warranty obligations, are subject not only to the unpredictability of future events but also to misstatements that may arise from using inadequate or inappropriate data or misapplying appropriate data. Since no one accounting estimate can be considered accurate with certainty, the auditor recognizes that a difference between an estimated amount best supported by the audit evidence and the estimated amount included in the financial statements may be reasonable, and such difference would not be considered to be a likely misstatement. However, if the auditor believes the estimated amount included in the financial statements is unreasonable, he or she should treat the difference between that estimate and the closest reasonable estimate as a likely misstatement and aggregate it with other likely misstatements. The auditor should also consider whether the difference between estimates best supported by the audit evidence and the estimates included in the financial statements, which are individually reasonable, indicate a possible bias on the part of the entity's management. For example, if each accounting estimate included in the financial statements was individually reasonable, but the effect of the difference between each estimate and the estimate best supported by the audit evidence was to increase income, the auditor should reconsider the estimates taken as a whole. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]

COPYRIGHT © 2002, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

- .37 In prior periods, likely misstatements may not have been corrected by the entity because they did not cause the financial statements for those periods to be materially misstated. Those misstatements might also affect the current period's financial statements. fn 15(22) If the auditor believes that there is an unacceptably high risk that the current period's financial statements may be materially misstated when those prior-period likely misstatements that affect the current period's financial statements are considered along with likely misstatements arising in the current period, the auditor should include in aggregate likely misstatement the effect on the current period's financial statements of those prior-period likely misstatements. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]
- .38 If the auditor concludes, based on the accumulation of sufficient evidential matter, that the aggregation of likely misstatements causes the financial statements to be materially misstated, the auditor should request management to eliminate the material misstatement. If the material misstatement is not eliminated, the auditor should issue a qualified or an adverse opinion on the financial statements. Material misstatements may be eliminated by, for example, application of appropriate accounting principles, other adjustments in amounts, or the addition of appropriate disclosure of inadequately disclosed matters. Even though the aggregate effect of likely misstatements on the financial statements may be immaterial, the auditor should recognize that an accumulation of immaterial misstatements in the balance sheet could contribute to material misstatements of future financial statements. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]
- .39 If the auditor concludes that the aggregation of likely misstatements does not cause the financial statements to be materially misstated, he or she should recognize that they could still be materially misstated because of further misstatement remaining undetected. As aggregate likely misstatement increases, the risk that the financial statements may be materially misstated also increases. The auditor generally reduces this risk of material misstatement in planning the audit by restricting the extent of detection risk he or she is willing to accept for an assertion related to an account balance or a class of transactions. The auditor can reduce this risk of material misstatement by modifying the nature, timing, and extent of planned auditing procedures on a continuous basis in performing the audit. (See paragraph .33.) Nevertheless, if the auditor believes that such risk is unacceptably high, he or she should perform additional auditing procedures or satisfy himself or herself that the entity has adjusted the financial statements to reduce the risk of material misstatement to an acceptable level. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]

COPYRIGHT © 2002, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

- .40** The auditor should document the nature and effect of aggregated misstatements. The auditor also should document his or her conclusion as to whether the aggregated misstatements cause the financial statements to be materially misstated. [Paragraph added, effective for audits of financial statements for periods beginning on or after May 15, 2002, by Statement on Auditing Standards No. 96.]
- .41** In aggregating known and likely misstatements that the entity has not corrected, pursuant to paragraphs .34 and .35, the auditor may designate an amount below which misstatements need not be accumulated. This amount should be set so that any such misstatements, either individually or when aggregated with other such misstatements, would not be material to the financial statements, after the possibility of further undetected misstatements is considered. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82. Paragraph renumbered by the issuance of Statement on Auditing Standards No. 96, January 2002.]

Effective Date

- .42** This section is effective for audits of financial statements for periods beginning after June 30, 1984. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997. Paragraph subsequently renumbered by the issuance of Statement on Auditing Standards No. 96, January 2002.]

AU Section 326

Evidential Matter

(Supersedes section 330, "Evidential Matter")

Source: SAS No. 31; SAS No. 48; SAS No. 80.

See section 9326 for interpretations of this section.

Issue date, unless otherwise indicated: August, 1980

- .01** The third standard of field work is:

Sufficient competent evidential matter is to be obtained through inspection,

COPYRIGHT © 2002, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.

- .02** Most of the independent auditor's work in forming his or her opinion on financial statements consists of obtaining and evaluating evidential matter fn 1 (23) concerning the assertions in such financial statements. The measure of the validity of such evidence for audit purposes lies in the judgment of the auditor; in this respect audit evidence differs from legal evidence, which is circumscribed by rigid rules. Evidential matter varies substantially in its influence on the auditor as he or she develops an opinion with respect to financial statements under audit. The pertinence of the evidence, its objectivity, its timeliness, and the existence of other evidential matter corroborating the conclusions to which it leads all bear on its competence.

Nature of Assertions

- .03** Assertions are representations by management that are embodied in financial statement components. They can be either explicit or implicit and can be classified according to the following broad categories:
- Existence or occurrence
 - Completeness
 - Rights and obligations
 - Valuation or allocation
 - Presentation and disclosure
- .04** Assertions about existence or occurrence address whether assets or liabilities of the entity exist at a given date and whether recorded transactions have occurred during a given period. For example, management asserts that finished goods inventories in the balance sheet are available for sale. Similarly, management asserts that sales in the income statement represent the exchange of goods or services with customers for cash or other consideration.
- .05** Assertions about completeness address whether all transactions and accounts that should be presented in the financial statements are so included. For example, management asserts that all purchases of goods and services are recorded and are included in the financial statements. Similarly, management asserts that notes payable in the balance sheet include all such obligations of the entity.

COPYRIGHT © 2002, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

- .06 Assertions about rights and obligations address whether assets are the rights of the entity and liabilities are the obligations of the entity at a given date. For example, management asserts that amounts capitalized for leases in the balance sheet represent the cost of the entity's rights to leased property and that the corresponding lease liability represents an obligation of the entity.
- .07 Assertions about valuation or allocation address whether asset, liability, equity, revenue, and expense components have been included in the financial statements at appropriate amounts. For example, management asserts that property is recorded at historical cost and that such cost is systematically allocated to appropriate accounting periods. Similarly, management asserts that trade accounts receivable included in the balance sheet are stated at net realizable value. [As amended, effective for engagements beginning on or after January 1, 1997, by Statement on Auditing Standards No. 80.]
- .08 Assertions about presentation and disclosure address whether particular components of the financial statements are properly classified, described, and disclosed. For example, management asserts that obligations classified as long-term liabilities in the balance sheet will not mature within one year. Similarly, management asserts that amounts presented as extraordinary items in the income statement are properly classified and described.

Use of Assertions in Developing Audit Objectives and Designing Substantive Tests

- .09 In obtaining evidential matter in support of financial statement assertions, the auditor develops specific audit objectives in the light of those assertions. In developing the audit objectives of a particular engagement, the auditor should consider the specific circumstances of the entity, including the nature of its economic activity and the accounting practices unique to its industry. For example, one audit objective related to the assertion about completeness that an auditor might develop for inventory balances is that inventory quantities include all products, materials, and supplies on hand.
- .10 There is not necessarily a one-to-one relationship between audit objectives and procedures. Some auditing procedures may relate to more than one objective. On the other hand, a combination of auditing procedures may be needed to achieve a single objective. Paragraph .26 provides illustrative audit objectives for inventories of a manufacturing company for each of the broad categories of assertions listed in paragraph .03 and examples of substantive tests that may achieve those audit objectives.

COPYRIGHT © 2002, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

- .11 In selecting particular substantive tests to achieve the audit objectives he or she has developed, an auditor considers, among other things, the risk of material misstatement of the financial statements, including the assessed levels of control risk, and the expected effectiveness and efficiency of such tests. These considerations include the nature and materiality of the items being tested, the kinds and competence of available evidential matter, and the nature of the audit objective to be achieved. For example, in designing substantive tests to achieve an objective related to the assertion of existence or occurrence, the auditor selects from items contained in a financial statement amount and searches for relevant evidential matter. On the other hand, in designing procedures to achieve an objective related to the assertion of completeness, the auditor selects from evidential matter indicating that an item should be included in the relevant financial statement amount and investigates whether that item is so included.
- .12 The auditor's specific audit objectives do not change whether information is processed manually or electronically. However, the methods of applying audit procedures to gather evidence may be influenced by the method of processing. The auditor may use either manual auditing procedures, information technology-assisted audit techniques, or a combination of both to obtain sufficient competent evidential matter. Because of the growth in the use of computers and other information technology, many entities process significant information electronically. Accordingly, it may be difficult or impossible for the auditor to access certain information for inspection, inquiry, or confirmation without using information technology. [Paragraph added, effective for periods beginning after August 31, 1984, by Statement on Auditing Standards No. 48. As amended, effective for engagements beginning on or after January 1, 1997, by Statement on Auditing Standards No. 80.]
- .13 The nature, timing, and extent of the procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor, based on the specific circumstances. However, the procedures adopted should be adequate to achieve the auditor's specific objectives and reduce detection risk to a level acceptable to the auditor. The evidential matter obtained should be sufficient for the auditor to form conclusions concerning the validity of the individual assertions embodied in the components of financial statements. The evidential matter provided by the combination of the auditor's assessment of inherent risk and control risk and on substantive tests should provide a reasonable basis for his or her opinion (see section 319, *Consideration of Internal Control in a Financial Statement Audit*, paragraphs .105 through .108). [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 48, July 1984. As amended, effective for engagements beginning on or after January 1, 1997, by Statement on Auditing Standards No. 80. Revised, May 2001, to reflect conforming

COPYRIGHT © 2002, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

changes necessary due to the issuance of Statement on Auditing Standards No. 94.]

- .14** In entities where significant information is transmitted, processed, maintained, or accessed electronically, the auditor may determine that it is not practical or possible to reduce detection risk to an acceptable level by performing only substantive tests for one or more financial statement assertions. For example, the potential for improper initiation or alteration of information to occur and not be detected may be greater if information is produced, maintained, or accessed only in electronic form. In such circumstances, the auditor should perform tests of controls to gather evidential matter to use in assessing control risk, fn 2(24) or consider the effect on his or her report (see paragraph .25 of this section). [Paragraph added, effective for engagements beginning on or after January 1, 1997, by Statement on Auditing Standards No. 80.]

Nature of Evidential Matter

- .15** Evidential matter supporting the financial statements consists of the underlying accounting data and all corroborating information available to the auditor. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 48, July 1984. Paragraph subsequently renumbered by the issuance of Statement on Auditing Standards No. 80, December 1996.]
- .16** The books of original entry, the general and subsidiary ledgers, related accounting manuals, and records such as work sheets and spreadsheets supporting cost allocations, computations, and reconciliations all constitute evidence in support of the financial statements. These accounting data are often in electronic form. Accounting data alone cannot be considered sufficient support for financial statements; on the other hand, without adequate attention to the propriety and accuracy of the underlying accounting data, an opinion on financial statements would not be warranted. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 48, July 1984. Paragraph subsequently renumbered and amended, effective for engagements beginning on or after January 1, 1997, by the issuance of Statement on Auditing Standards No. 80.]
- .17** Corroborating evidential matter includes both written and electronic information such as checks; records of electronic fund transfers; invoices; contracts; minutes of meetings; confirmations and other written representations by knowledgeable people; information obtained by the auditor from inquiry, observation, inspection, and physical examination; and other information developed by, or available to, the auditor which permits him or her to reach conclusions through valid reasoning. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 48, July 1984. Paragraph subsequently renumbered

COPYRIGHT © 2002, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

and amended, effective for engagements beginning on or after January 1, 1997, by the issuance of Statement on Auditing Standards No. 80.]

- .18 In certain entities, some of the accounting data and corroborating evidential matter are available only in electronic form. Source documents such as purchase orders, bills of lading, invoices, and checks are replaced with electronic messages. For example, entities may use Electronic Data Interchange (EDI) or image processing systems. In EDI, the entity and its customers or suppliers use communication links to transact business electronically. Purchase, shipping, billing, cash receipt, and cash disbursement transactions are often consummated entirely by the exchange of electronic messages between the parties. In image processing systems, documents are scanned and converted into electronic images to facilitate storage and reference, and the source documents may not be retained after conversion. Certain electronic evidence may exist at a certain point in time. However, such evidence may not be retrievable after a specified period of time if files are changed and if backup files do not exist. Therefore, the auditor should consider the time during which information exists or is available in determining the nature, timing, and extent of his or her substantive tests, and, if applicable, tests of controls. [Paragraph added, effective for engagements beginning on or after January 1, 1997, by Statement on Auditing Standards No. 80.]
- .19 The auditor tests underlying accounting data by (a) analysis and review, (b) retracing the procedural steps followed in the accounting process and in developing the allocations involved, (c) recalculation, and (d) reconciling related types and applications of the same information. Through the performance of such procedures, the auditor may determine that the accounting records are internally consistent. Such internal consistency ordinarily provides evidence about the fairness of presentation of the financial statements. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 48, July 1984. Paragraph subsequently renumbered and amended, effective for engagements beginning on or after January 1, 1997, by the issuance of Statement on Auditing Standards No. 80.]
- .20 The pertinent accounting data and corroborating evidential matter to support entries in the accounts and assertions in the financial statements ordinarily are available from the entity's files and accessible to the auditor for examination at certain points or periods in time. Both within the entity's organization and outside it are knowledgeable people to whom the auditor can direct inquiries. Assets having physical existence are available to the auditor for his or her inspection. Activities of the entity's personnel can be observed. Based on observations of these or other conditions or circumstances, the auditor may reach conclusions about the validity of various assertions in the financial statements. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 48, July 1984.]

COPYRIGHT © 2002, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

Paragraph subsequently renumbered and amended, effective for engagements beginning on or after January 1, 1997, by the issuance of Statement on Auditing Standards No. 80.]

Competence of Evidential Matter

- .21** To be competent, evidence, regardless of its form, must be both valid and relevant. The validity of evidential matter is so dependent on the circumstances under which it is obtained that generalizations about the reliability of various kinds of evidence are subject to important exceptions. If the possibility of important exceptions is recognized, however, the following presumptions, which are not mutually exclusive, about the validity of evidential matter in auditing have some usefulness:
- a.* When evidential matter can be obtained from independent sources outside an entity, it provides greater assurance of reliability for the purposes of an independent audit than that secured solely within the entity.
 - b.* The more effective the internal control, the more assurance it provides about the reliability of the accounting data and financial statements.
 - c.* The independent auditor's direct personal knowledge, obtained through physical examination, observation, computation, and inspection, is more persuasive than information obtained indirectly.

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 48, July 1984. Paragraph subsequently renumbered and amended, effective for engagements beginning on or after January 1, 1997, by the issuance of Statement on Auditing Standards No. 80.]

Sufficiency of Evidential Matter

- .22** The independent auditor's objective is to obtain sufficient competent evidential matter to provide him or her with a reasonable basis for forming an opinion. The amount and kinds of evidential matter required to support an informed opinion are matters for the auditor to determine in the exercise of his or her professional judgment after a careful study of the circumstances in the particular case. However, in the great majority of cases, the auditor has to rely on evidence that is persuasive rather than convincing. Both the individual assertions in financial statements and the overall proposition that the financial statements as a whole are fairly presented are of such a nature that even an experienced auditor is seldom convinced beyond all doubt with respect to all aspects of the statements being audited. [Paragraph renumbered by the issuance of Statement on Auditing Standards No.

COPYRIGHT © 2002, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

48, July 1984. Paragraph subsequently renumbered and amended, effective for engagements beginning on or after January 1, 1997, by the issuance of Statement on Auditing Standards No. 80.]

.23 An auditor typically works within economic limits; the auditor's opinion, to be economically useful, must be formed within a reasonable length of time and at reasonable cost. The auditor must decide, again exercising professional judgment, whether the evidential matter available to him or her within the limits of time and cost is sufficient to justify expression of an opinion. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 48, July 1984. Paragraph subsequently renumbered by the issuance of Statement on Auditing Standards No. 80, December 1996.]

.24 As a guiding rule, there should be a rational relationship between the cost of obtaining evidence and the usefulness of the information obtained. The matter of difficulty and expense involved in testing a particular item is not in itself a valid basis for omitting the test. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 48, July 1984. Paragraph subsequently renumbered by the issuance of Statement on Auditing Standards No. 80, December 1996.]

Evaluation of Evidential Matter

.25 In evaluating evidential matter, the auditor considers whether specific audit objectives have been achieved. The independent auditor should be thorough in his or her search for evidential matter and unbiased in its evaluation. In designing audit procedures to obtain competent evidential matter, he or she should recognize the possibility that the financial statements may not be fairly presented in conformity with generally accepted accounting principles or a comprehensive basis of accounting other than generally accepted accounting principles. fn 3(25) In developing his or her opinion, the auditor should consider relevant evidential matter regardless of whether it appears to corroborate or to contradict the assertions in the financial statements. To the extent the auditor remains in substantial doubt about any assertion of material significance, he or she must refrain from forming an opinion until he or she has obtained sufficient competent evidential matter to remove such substantial doubt, or the auditor must express a qualified opinion or a disclaimer of opinion. fn 4(26) [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 48, July 1984. Paragraph subsequently renumbered and amended, effective for engagements beginning on or after January 1, 1997, by the issuance of Statement on Auditing Standards No. 80.]

COPYRIGHT © 2002, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

Appendix

Financial Statement Assertions, Illustrative Audit Objectives, and Examples of Substantive Tests

.26

Illustrations for Inventories of a Manufacturing Company

This appendix illustrates the use of assertions in developing audit objectives and designing substantive tests. The following examples of substantive tests are not intended to be all-inclusive nor is it expected that all of the procedures would be applied in an audit.

<u>Illustrative Audit Objectives</u>	<u>Examples of Substantive Tests</u>
<u>Existence or Occurrence</u>	
Inventories included in the balance sheet physically exist	<ul style="list-style-type: none"> • Observing physical inventory counts • Obtaining confirmation of inventories at locations outside the entity • Testing of inventory transactions between a preliminary physical inventory date and the balance sheet date.
Inventories represent items held for sale or use in the normal course of business.	<ul style="list-style-type: none"> • Reviewing perpetual inventory records, production records, and purchasing records for indications of current activity. • Comparing inventories with a current sales catalog and subsequent sales and delivery reports. • Using the work of specialists to corroborate the nature of specialized products.
<u>Completeness</u>	
Inventory quantities include all products, materials, and supplies on hand	<ul style="list-style-type: none"> • Observing physical inventory counts

COPYRIGHT © 2002, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

Inventory quantities include all products, materials, and supplies owned by the company that are in transit or stored at outside locations.

- Analytically comparing the relationship of inventory balances to recent purchasing, production, and sales activities.

- Testing shipping and receiving cutoff procedures.

- Obtaining confirmation of inventories at locations outside the entity.

- Analytically comparing the relationship of inventory balances to recent purchasing, production, and sales activities.

- Testing shipping and receiving cutoff procedures.

Inventory listings are accurately compiled and the totals are properly included in the inventory accounts.

- Tracing test counts recorded during the physical inventory observation to the inventory listing.

- Accounting for all inventory tags and count sheets used in recording the physical inventory counts.

- Testing the clerical accuracy of inventory listings.

- Reconciling physical counts to perpetual records and general ledger balances and investigating significant fluctuations.

Rights and Obligations

The entity has legal title or similar rights of ownership to the inventories.

- Observing physical inventory counts.

- Obtaining confirmation of inventories at locations outside the entity.

- Examining paid vendors' invoices, consignment agreements, and contracts.

COPYRIGHT © 2002, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

Inventories are properly classified in the balance sheet as current assets.	• Reviewing drafts of the financial statements.
The major categories of inventories and their bases of valuation are adequately disclosed in the financial statements.	• Reviewing drafts of the financial statements.
	• Comparing the disclosures made in the financial statements to the requirements of generally accepted accounting principles.
The pledge or assignment of any inventories is appropriately disclosed.	• Obtaining confirmation of inventories pledged under loan agreements.

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 48, July 1984. Paragraph subsequently renumbered by the issuance of Statement on Auditing Standards No. 80, December 1996.]

AU Section 334

Related Parties

(Supersedes Statement on Auditing Standards No. 6, AICPA, *Professional Standards*, vol. 1, AU sec. 335.01-.19) fn *(27)

Source: SAS No. 45.

See section 9334 for interpretations of this section.

Effective for periods ended after September 30, 1983, unless otherwise indicated.

- .01 This section provides guidance on procedures that should be considered by the auditor when he is performing an audit of financial statements in accordance with generally accepted auditing standards to identify related party relationships and transactions and to satisfy himself concerning the required financial statement accounting and disclosure. fn 1(28) The procedures set forth in this section should not be considered all-inclusive. Also, not all of them may be required in every audit.

COPYRIGHT © 2002, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

Accounting Considerations

- .02 FASB Statement No. 57, *Related Party Disclosures* [AC section R36], gives the requirements for related party disclosures. Certain accounting pronouncements prescribe the accounting treatment when related parties are involved; however, established accounting principles ordinarily do not require transactions with related parties to be accounted for on a basis different from that which would be appropriate if the parties were not related. The auditor should view related party transactions within the framework of existing pronouncements, placing primary emphasis on the adequacy of disclosure. In addition, the auditor should be aware that the substance of a particular transaction could be significantly different from its form and that financial statements should recognize the substance of particular transactions rather than merely their legal form. fn 2(29)
- .03 Transactions that because of their nature may be indicative of the existence of related parties include fn 3 (30)—
- a. Borrowing or lending on an interest-free basis or at a rate of interest significantly above or below market rates prevailing at the time of the transaction.
 - b. Selling real estate at a price that differs significantly from its appraised value.
 - c. Exchanging property for similar property in a nonmonetary transaction.
 - d. Making loans with no scheduled terms for when or how the funds will be repaid.

Audit Procedures

- .04 An audit performed in accordance with generally accepted auditing standards cannot be expected to provide assurance that all related party transactions will be discovered. Nevertheless, during the course of his audit, the auditor should be aware of the possible existence of material related party transactions that could affect the financial statements and of common ownership or management control relationships for which FASB Statement No. 57 [AC section R36] requires disclosure even though there are no transactions. Many of the procedures outlined in the following paragraphs are normally performed in an audit in accordance with generally accepted auditing standards, even if the auditor has no reason to suspect that related party transactions or control relationships exist. Other audit procedures set forth in this section are specifically directed to related party transactions.

COPYRIGHT © 2002, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

- .05** In determining the scope of work to be performed with respect to possible transactions with related parties, the auditor should obtain an understanding of management responsibilities and the relationship of each component to the total entity. He should consider controls over management activities, and he should consider the business purpose served by the various components of the entity. Normally, the business structure and style of operating are based on the abilities of management, tax and legal considerations, product diversification, and geographical location. Experience has shown, however, that business structure and operating style are occasionally deliberately designed to obscure related party transactions.
- .06** In the absence of evidence to the contrary, transactions with related parties should not be assumed to be outside the ordinary course of business. The auditor should, however, be aware of the possibility that transactions with related parties may have been motivated solely, or in large measure, by conditions similar to the following:
- a.* Lack of sufficient working capital or credit to continue the business
 - b.* An urgent desire for a continued favorable earnings record in the hope of supporting the price of the company's stock
 - c.* An overly optimistic earnings forecast
 - d.* Dependence on a single or relatively few products, customers, or transactions for the continuing success of the venture
 - e.* A declining industry characterized by a large number of business failures
 - f.* Excess capacity
 - g.* Significant litigation, especially litigation between stockholders and management
 - h.* Significant obsolescence dangers because the company is in a high-technology industry

Determining the Existence of Related Parties

- .07** The auditor should place emphasis on testing material transactions with parties he knows are related to the reporting entity. Certain relationships, such as parent-subsidiary or investor-investee, may be clearly evident. Determining the existence of others requires the application of specific audit procedures, which may include the following:

25

COPYRIGHT © 2002, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

AU Section 326

Evidential Matter

(Supersedes section 330, "Evidential Matter")

Source: SAS No. 31; SAS No. 48; SAS No. 80.

See section 9326 for interpretations of this section.

Issue date, unless otherwise indicated: August, 1980

.01 The third standard of field work is:

Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.

.02 Most of the independent auditor's work in forming his or her opinion on financial statements consists of obtaining and evaluating evidential matter fn 1 (1) concerning the assertions in such financial statements. The measure of the validity of such evidence for audit purposes lies in the judgment of the auditor; in this respect audit evidence differs from legal evidence, which is circumscribed by rigid rules. Evidential matter varies substantially in its influence on the auditor as he or she develops an opinion with respect to financial statements under audit. The pertinence of the evidence, its objectivity, its timeliness, and the existence of other evidential matter corroborating the conclusions to which it leads all bear on its competence.

Nature of Assertions

.03 Assertions are representations by management that are embodied in financial statement components. They can be either explicit or implicit and can be classified according to the following broad categories:

- Existence or occurrence
- Completeness
- Rights and obligations

COPYRIGHT © 2002, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

- Valuation or allocation
 - Presentation and disclosure
- .04 Assertions about existence or occurrence address whether assets or liabilities of the entity exist at a given date and whether recorded transactions have occurred during a given period. For example, management asserts that finished goods inventories in the balance sheet are available for sale. Similarly, management asserts that sales in the income statement represent the exchange of goods or services with customers for cash or other consideration.
- .05 Assertions about completeness address whether all transactions and accounts that should be presented in the financial statements are so included. For example, management asserts that all purchases of goods and services are recorded and are included in the financial statements. Similarly, management asserts that notes payable in the balance sheet include all such obligations of the entity.
- .06 Assertions about rights and obligations address whether assets are the rights of the entity and liabilities are the obligations of the entity at a given date. For example, management asserts that amounts capitalized for leases in the balance sheet represent the cost of the entity's rights to leased property and that the corresponding lease liability represents an obligation of the entity.
- .07 Assertions about valuation or allocation address whether asset, liability, equity, revenue, and expense components have been included in the financial statements at appropriate amounts. For example, management asserts that property is recorded at historical cost and that such cost is systematically allocated to appropriate accounting periods. Similarly, management asserts that trade accounts receivable included in the balance sheet are stated at net realizable value. [As amended, effective for engagements beginning on or after January 1, 1997, by Statement on Auditing Standards No. 80.]
- .08 Assertions about presentation and disclosure address whether particular components of the financial statements are properly classified, described, and disclosed. For example, management asserts that obligations classified as long-term liabilities in the balance sheet will not mature within one year. Similarly, management asserts that amounts presented as extraordinary items in the income statement are properly classified and described.

Use of Assertions in Developing Audit Objectives and Designing Substantive

COPYRIGHT © 2002, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

Tests

- .09 In obtaining evidential matter in support of financial statement assertions, the auditor develops specific audit objectives in the light of those assertions. In developing the audit objectives of a particular engagement, the auditor should consider the specific circumstances of the entity, including the nature of its economic activity and the accounting practices unique to its industry. For example, one audit objective related to the assertion about completeness that an auditor might develop for inventory balances is that inventory quantities include all products, materials, and supplies on hand.
- .10 There is not necessarily a one-to-one relationship between audit objectives and procedures. Some auditing procedures may relate to more than one objective. On the other hand, a combination of auditing procedures may be needed to achieve a single objective. Paragraph .26 provides illustrative audit objectives for inventories of a manufacturing company for each of the broad categories of assertions listed in paragraph .03 and examples of substantive tests that may achieve those audit objectives.
- .11 In selecting particular substantive tests to achieve the audit objectives he or she has developed, an auditor considers, among other things, the risk of material misstatement of the financial statements, including the assessed levels of control risk, and the expected effectiveness and efficiency of such tests. These considerations include the nature and materiality of the items being tested, the kinds and competence of available evidential matter, and the nature of the audit objective to be achieved. For example, in designing substantive tests to achieve an objective related to the assertion of existence or occurrence, the auditor selects from items contained in a financial statement amount and searches for relevant evidential matter. On the other hand, in designing procedures to achieve an objective related to the assertion of completeness, the auditor selects from evidential matter indicating that an item should be included in the relevant financial statement amount and investigates whether that item is so included.
- .12 The auditor's specific audit objectives do not change whether information is processed manually or electronically. However, the methods of applying audit procedures to gather evidence may be influenced by the method of processing. The auditor may use either manual auditing procedures, information technology-assisted audit techniques, or a combination of both to obtain sufficient competent evidential matter. Because of the growth in the use of computers and other information technology, many entities process significant information electronically. Accordingly, it may be difficult or impossible for the auditor to access certain information for inspection, inquiry, or confirmation without using information technology. [Paragraph added, effective for periods beginning after August

COPYRIGHT © 2002, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

31, 1984, by Statement on Auditing Standards No. 48. As amended, effective for engagements beginning on or after January 1, 1997, by Statement on Auditing Standards No. 80.]

- .13 The nature, timing, and extent of the procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor, based on the specific circumstances. However, the procedures adopted should be adequate to achieve the auditor's specific objectives and reduce detection risk to a level acceptable to the auditor. The evidential matter obtained should be sufficient for the auditor to form conclusions concerning the validity of the individual assertions embodied in the components of financial statements. The evidential matter provided by the combination of the auditor's assessment of inherent risk and control risk and on substantive tests should provide a reasonable basis for his or her opinion (see section 319, *Consideration of Internal Control in a Financial Statement Audit*, paragraphs .105 through .108). [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 48, July 1984. As amended, effective for engagements beginning on or after January 1, 1997, by Statement on Auditing Standards No. 80. Revised, May 2001, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 94.]
- .14 In entities where significant information is transmitted, processed, maintained, or accessed electronically, the auditor may determine that it is not practical or possible to reduce detection risk to an acceptable level by performing only substantive tests for one or more financial statement assertions. For example, the potential for improper initiation or alteration of information to occur and not be detected may be greater if information is produced, maintained, or accessed only in electronic form. In such circumstances, the auditor should perform tests of controls to gather evidential matter to use in assessing control risk, in 2(2) or consider the effect on his or her report (see paragraph .25 of this section). [Paragraph added, effective for engagements beginning on or after January 1, 1997, by Statement on Auditing Standards No. 80.]

Nature of Evidential Matter

- .15 Evidential matter supporting the financial statements consists of the underlying accounting data and all corroborating information available to the auditor. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 48, July 1984. Paragraph subsequently renumbered by the issuance of Statement on Auditing Standards No. 80, December 1996.]
- .16 The books of original entry, the general and subsidiary ledgers, related accounting

COPYRIGHT © 2002, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

manuals, and records such as work sheets and spreadsheets supporting cost allocations, computations, and reconciliations all constitute evidence in support of the financial statements. These accounting data are often in electronic form. Accounting data alone cannot be considered sufficient support for financial statements; on the other hand, without adequate attention to the propriety and accuracy of the underlying accounting data, an opinion on financial statements would not be warranted. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 48, July 1984. Paragraph subsequently renumbered and amended, effective for engagements beginning on or after January 1, 1997, by the issuance of Statement on Auditing Standards No. 80.]

- .17 Corroborating evidential matter includes both written and electronic information such as checks; records of electronic fund transfers; invoices; contracts; minutes of meetings; confirmations and other written representations by knowledgeable people; information obtained by the auditor from inquiry, observation, inspection, and physical examination; and other information developed by, or available to, the auditor which permits him or her to reach conclusions through valid reasoning. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 48, July 1984. Paragraph subsequently renumbered and amended, effective for engagements beginning on or after January 1, 1997, by the issuance of Statement on Auditing Standards No. 80.]
- .18 In certain entities, some of the accounting data and corroborating evidential matter are available only in electronic form. Source documents such as purchase orders, bills of lading, invoices, and checks are replaced with electronic messages. For example, entities may use Electronic Data Interchange (EDI) or image processing systems. In EDI, the entity and its customers or suppliers use communication links to transact business electronically. Purchase, shipping, billing, cash receipt, and cash disbursement transactions are often consummated entirely by the exchange of electronic messages between the parties. In image processing systems, documents are scanned and converted into electronic images to facilitate storage and reference, and the source documents may not be retained after conversion. Certain electronic evidence may exist at a certain point in time. However, such evidence may not be retrievable after a specified period of time if files are changed and if backup files do not exist. Therefore, the auditor should consider the time during which information exists or is available in determining the nature, timing, and extent of his or her substantive tests, and, if applicable, tests of controls. [Paragraph added, effective for engagements beginning on or after January 1, 1997, by Statement on Auditing Standards No. 80.]
- .19 The auditor tests underlying accounting data by (a) analysis and review, (b) retracing the procedural steps followed in the accounting process and in developing the allocations involved, (c) recalculation, and (d) reconciling related types and applications of the same

COPYRIGHT © 2002, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

information. Through the performance of such procedures, the auditor may determine that the accounting records are internally consistent. Such internal consistency ordinarily provides evidence about the fairness of presentation of the financial statements.

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 48, July 1984. Paragraph subsequently renumbered and amended, effective for engagements beginning on or after January 1, 1997, by the issuance of Statement on Auditing Standards No. 80.]

- .20 The pertinent accounting data and corroborating evidential matter to support entries in the accounts and assertions in the financial statements ordinarily are available from the entity's files and accessible to the auditor for examination at certain points or periods in time. Both within the entity's organization and outside it are knowledgeable people to whom the auditor can direct inquiries. Assets having physical existence are available to the auditor for his or her inspection. Activities of the entity's personnel can be observed. Based on observations of these or other conditions or circumstances, the auditor may reach conclusions about the validity of various assertions in the financial statements. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 48, July 1984. Paragraph subsequently renumbered and amended, effective for engagements beginning on or after January 1, 1997, by the issuance of Statement on Auditing Standards No. 80.]

Competence of Evidential Matter

- .21 To be competent, evidence, regardless of its form, must be both valid and relevant. The validity of evidential matter is so dependent on the circumstances under which it is obtained that generalizations about the reliability of various kinds of evidence are subject to important exceptions. If the possibility of important exceptions is recognized, however, the following presumptions, which are not mutually exclusive, about the validity of evidential matter in auditing have some usefulness:
- a. When evidential matter can be obtained from independent sources outside an entity, it provides greater assurance of reliability for the purposes of an independent audit than that secured solely within the entity.
 - b. The more effective the internal control, the more assurance it provides about the reliability of the accounting data and financial statements.
 - c. The independent auditor's direct personal knowledge, obtained through physical examination, observation, computation, and inspection, is more persuasive than information obtained indirectly.

COPYRIGHT © 2002, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 48, July 1984. Paragraph subsequently renumbered and amended, effective for engagements beginning on or after January 1, 1997, by the issuance of Statement on Auditing Standards No. 80.]

Sufficiency of Evidential Matter

- .22 The independent auditor's objective is to obtain sufficient competent evidential matter to provide him or her with a reasonable basis for forming an opinion. The amount and kinds of evidential matter required to support an informed opinion are matters for the auditor to determine in the exercise of his or her professional judgment after a careful study of the circumstances in the particular case. However, in the great majority of cases, the auditor has to rely on evidence that is persuasive rather than convincing. Both the individual assertions in financial statements and the overall proposition that the financial statements as a whole are fairly presented are of such a nature that even an experienced auditor is seldom convinced beyond all doubt with respect to all aspects of the statements being audited. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 48, July 1984. Paragraph subsequently renumbered and amended, effective for engagements beginning on or after January 1, 1997, by the issuance of Statement on Auditing Standards No. 80.]
- .23 An auditor typically works within economic limits; the auditor's opinion, to be economically useful, must be formed within a reasonable length of time and at reasonable cost. The auditor must decide, again exercising professional judgment, whether the evidential matter available to him or her within the limits of time and cost is sufficient to justify expression of an opinion. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 48, July 1984. Paragraph subsequently renumbered by the issuance of Statement on Auditing Standards No. 80, December 1996.]
- .24 As a guiding rule, there should be a rational relationship between the cost of obtaining evidence and the usefulness of the information obtained. The matter of difficulty and expense involved in testing a particular item is not in itself a valid basis for omitting the test. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 48, July 1984. Paragraph subsequently renumbered by the issuance of Statement on Auditing Standards No. 80, December 1996.]

Evaluation of Evidential Matter

COPYRIGHT © 2002, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

- .25 In evaluating evidential matter, the auditor considers whether specific audit objectives have been achieved. The independent auditor should be thorough in his or her search for evidential matter and unbiased in its evaluation. In designing audit procedures to obtain competent evidential matter, he or she should recognize the possibility that the financial statements may not be fairly presented in conformity with generally accepted accounting principles or a comprehensive basis of accounting other than generally accepted accounting principles. fn 3(3) In developing his or her opinion, the auditor should consider relevant evidential matter regardless of whether it appears to corroborate or to contradict the assertions in the financial statements. To the extent the auditor remains in substantial doubt about any assertion of material significance, he or she must refrain from forming an opinion until he or she has obtained sufficient competent evidential matter to remove such substantial doubt, or the auditor must express a qualified opinion or a disclaimer of opinion. fn 4(4) [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 48, July 1984. Paragraph subsequently renumbered and amended, effective for engagements beginning on or after January 1, 1997, by the issuance of Statement on Auditing Standards No. 80.]

Appendix

Financial Statement Assertions, Illustrative Audit Objectives, and Examples of Substantive Tests

.26

Illustrations for Inventories of a Manufacturing Company

This appendix illustrates the use of assertions in developing audit objectives and designing substantive tests. The following examples of substantive tests are not intended to be all-inclusive nor is it expected that all of the procedures would be applied in an audit.

<u>Illustrative Audit Objectives</u>	<u>Examples of Substantive Tests</u>
<u>Existence or Occurrence</u>	
Inventories included in the balance sheet physically exist	<ul style="list-style-type: none"> • Observing physical inventory counts • Obtaining confirmation of inventories at locations outside the entity

COPYRIGHT © 2002, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

Inventories represent items held for sale or use in the normal course of business.

- Testing of inventory transactions between a preliminary physical inventory date and the balance sheet date.
- Reviewing perpetual inventory records, production records, and purchasing records for indications of current activity.
- Comparing inventories with a current sales catalog and subsequent sales and delivery reports.
- Using the work of specialists to corroborate the nature of specialized products.

Completeness

Inventory quantities include all products, materials, and supplies on hand

- Observing physical inventory counts
- Analytically comparing the relationship of inventory balances to recent purchasing, production, and sales activities.
- Testing shipping and receiving cutoff procedures.

Inventory quantities include all products, materials, and supplies owned by the company that are in transit or stored at outside locations.

- Obtaining confirmation of inventories at locations outside the entity.
- Analytically comparing the relationship of inventory balances to recent purchasing, production, and sales activities.
- Testing shipping and receiving cutoff procedures.

Inventory listings are accurately compiled and the totals are properly included in the inventory accounts.

- Tracing test counts recorded during the physical inventory observation to the inventory listing.
- Accounting for all inventory tags and count sheets used in recording the physical inventory counts.

COPYRIGHT © 2002, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

- Testing the clerical accuracy of inventory listings.
- Reconciling physical counts to perpetual records and general ledger balances and investigating significant fluctuations.

Rights and Obligations

The entity has legal title or similar rights of ownership to the inventories.

- Observing physical inventory counts.
- Obtaining confirmation of inventories at locations outside the entity.
- Examining paid vendors' invoices, consignment agreements, and contracts.

Inventories exclude items billed to customers or owned by others.

- Examining paid vendors' invoices, consignment agreements, and contracts.
- Testing shipping and receiving cutoff procedures.

Valuation or Allocation

Inventories are properly stated at cost (except when market is lower).

- Examining paid vendors' invoices.
- Reviewing direct labor rates.
- Testing the computation of standard overhead rates.
- Examining analyses of purchasing and manufacturing standard cost variances.

Slow-moving, excess, defective, and obsolete items included in inventories are properly identified.

- Examining an analysis of inventory turnover.
- Reviewing industry experience and trends.

PART II: PRIMARY DIRECTION OF OVERALL INHERENT RISK

The factors indicated in PART IA, while not actually creating inherent risk, sometimes generate management motivations that cause the risk factors in PART IB, when present, to manifest themselves primarily in a particular direction.

After determining materiality (see Form B-3, CHECKLIST FOR DETERMINING MATERIALITY), consider the significance of the risk factors listed in PART IB, in terms of their likelihood of contributing to a material (>MTM) misstatement in the financial statements, and whether the indicated risk factors in PARTs I, A or B, suggest management motivation or any other reason to expect a substantially higher probability of misstatements in one particular direction.

- For those risk factors indicated in PART I as present, enter the appropriate codes in the right column, as follows:
 O = Significantly contributes to OVERSTATEMENT (of assets/income) risk
 U = Significantly contributes to UNDERSTATEMENT risk
 C = Significantly contributes to CONTROL risk (refer to in preparing Form B-2A, CHECKLIST FOR ASSESSING CONTROL ENVIRONMENT)
 N = Relatively insignificant

Documentation of principal reasons for the foregoing evaluations may be noted in PART IV, or in an attachment.

- Based on the risk factors identified as significant, determine if there is any primary direction of inherent risk. If yes, indicate primary direction of overall inherent risk (see also Forms B-9, CYCLE RISK ASSESSMENT):
 (Check one) ☒ OVERSTATEMENT ☐ UNDERSTATEMENT ☐ BIDIRECTIONAL
 and note principal reason(s):

CONVING CO. - BANK EXPERT FAVORABLE FINANCIAL STATEMENTS

- Use the accompanying matrix (PART IV) to summarize and evaluate identified inherent risk factors (including those indicated as relatively insignificant), any mitigating circumstances (including factors contributing to a preliminary control risk assessment of moderate or low) and the effects, if any, given to them in the selection and scope of substantive audit procedures.

PART III: OVERALL AUDIT RISK CONCLUSION

Audit risk is the risk of issuing an inappropriate opinion on the financial statements, for example, an unqualified opinion when they are materially misstated. As we know, it is a function of three principal risk component factors, the first two of which (inherent and control risk) are client-associated, and the third (detection risk), which is auditor controlled. Consequently, audit risk is an expression of how much risk the auditor is willing to accept by being associated with the financial statements. (The lower the acceptable audit risk level, the more auditing is necessary.) It is determined or set judgmentally based on circumstances, particularly business risk factors. Maximum acceptable audit risk, as determined on an overall basis for the audit as a whole, generally applies to all significant cycles, and only in the primary direction, if any. A higher acceptable level of audit risk ordinarily applies to insignificant cycles and assertions. However, special circumstances may give rise to use of a lower acceptable audit risk for certain sensitive cycles or assertions.

Since inherent risk is only a component of audit risk, it has an independent effect on audit scope. The higher the inherent risk, the more auditing necessary to achieve the desired maximum audit risk level. But since many inherent risk factors (most particularly those in PART IB of this checklist that relate to management integrity and attitudes) likewise contribute significantly to business risk, they may further affect audit scope when considered, along with those relating primarily to financial statement user needs and expectations, by limiting maximum acceptable audit risk. (Although one might expect that a high level of inherent risk would lead to a lower acceptable audit risk, the opposite is possible because these factors function independently to influence audit scope. Likewise, it is possible to have low inherent risk, yet because of business risk factors that do not cause inherent risk, such as those listed in PART IA, only a low audit risk level is acceptable.)

As a guide, one might view "high", "moderate" and "low" audit risk, as the approximate equivalent of a 20%, 10% and 5% risk of incorrect acceptance, respectively, as might be used in a sampling application when there will be moderate reliance on an analytical or other corroborative substantive test, and no reliance on any test of internal controls.

Considering the factors (PARTs IA and B, and PART II) as business risk factors, determine whether the maximum acceptable audit risk level (applicable to the primary direction of risk, or both directions, if equal) should be:

(Check one) ☐ HIGH (minimum scope, consistent with GAAS) ☒ MODERATE ☐ LOW (highest scope)

Note principal reason(s):

INHERENT & CONTROL RISK ARE NORMAL - HISTORICALLY NO SIGNIFICANT PROBLEMS HAVE BEEN FOUND. (*)

Prepared by

Bole

Date

12/3/96

Approved by

Date

BSSF 1063

10/94

(*)

CHOICE BETWEEN HIGH OR MODERATE ACCEPTABLE AUDIT RISK LEVELS DOES NOT AFFECT AUDIT SCOPE!

BS 00774

12/31/97

Planning notes

Date 12/1/97	Prepared By Bow	Work Paper No.
	Reviewed By Euf	

- Insurance policies with premiums totalling approx 1 million will be purchased from F&I prior to year end.
- All other related party transactions are insignificant. Cancelled reimbursements for services rendered or amounts paid on their behalf.
- new debt for purchase of house equipment.
- new lease agreements for house equipment.
- Self performing HVAC and electrical. Hired several new employees. Started at the end of 1997.

BSSF2727

BS 02045

COPY

IN THE UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF PENNSYLVANIA

UNITED STATES FIDELITY AND :
GUARANTY COMPANY, :
: CIVIL ACTION
PLAINTIFF : NO. 1:01-CV-00813
:
V :
:
BRUCE J. BROWN AND BROWN SCHULTZ: JUDGE KANE
SHERIDAN & FRITZ, :
:
DEFENDANTS :

DEPOSITION OF: JOHN M. ORTENZIO

TAKEN BY: PLAINTIFF

BEFORE: TAMMY J. BAKER, REPORTER
NOTARY PUBLIC

DATE: MAY 23, 2002, 10:19 A.M.

PLACE: THOMAS, THOMAS & HAER
305 NORTH FRONT STREET
HARRISBURG, PENNSYLVANIA

APPEARANCES:

BERNKOPF, GOODMAN & BASEMAN, LLP
BY: PETER B. McGLYNN, ESQUIRE

FOR - PLAINTIFF

SWARTZ, CAMPBELL & DETWILER
BY: KATHLEEN M. CARSON, ESQUIRE

FOR - DEFENDANTS



Page 82

1 construction accounting.
 2 Q Did you ever discuss with Mr. Brown what that
 3 construction knowledge consisted of?
 4 MS. CARSON: Objection to the form.
 5 THE WITNESS: Only to the extent probably when I
 6 first met him was how many construction companies was he
 7 doing, was that something that they did.
 8 BY MR. McGLYNN:
 9 Q Did you ever discuss with him at that time or any
 10 other time that one of the things that CCI needed was for
 11 Brown Schultz to prepare audited financial statements for
 12 bonding companies?
 13 MS. CARSON: Object to the form.
 14 THE WITNESS: Are you talking about at the
 15 inception of the relationship or. . .
 16 BY MR. McGLYNN:
 17 Q At the inception of the relationship?
 18 A At the inception of the relationship, no.
 19 Q How about any time thereafter?
 20 A Later, sure.
 21 Q You specifically discussed with Bruce Brown the
 22 fact that CCI needed an audited financial statement each
 23 year for USF&G?
 24 MS. CARSON: Object to the form.
 25 THE WITNESS: No. There came a point in time

Page 83

1 where I said to Bruce Brown that -- and this would have been
 2 after doing a number of years of reviewed statements -- I
 3 indicated to Bruce Brown that probably what I needed to
 4 start doing was to have an audit as opposed to a review and
 5 that would have come at a point in time when I had a
 6 stronger person in the controller's position and the company
 7 was growing and for whatever reason at that point in time I
 8 felt that it was better for the company going forward on a
 9 long term basis to have an audited statement as opposed to a
 10 review; though at that specific and particular time the
 11 issue of having it specifically for a bonding company I
 12 don't think was part of the reasoning.
 13 BY MR. McGLYNN:
 14 Q But that changed at some point in time in the
 15 future?
 16 A Somewhere later it changed.
 17 Q And that was communicated by you to Mr. Brown?
 18 MS. CARSON: Object to the form.
 19 THE WITNESS: When the change going from a review
 20 to an audit occurred?
 21 BY MR. McGLYNN:
 22 Q Did you have any discussions at any time with
 23 Bruce Brown, you directly with Bruce Brown concerning
 24 USF&G's need for audited financial statements on an annual
 25 basis?

Page

1 MS. CARSON: Object to the form.
 2 BY MR. McGLYNN:
 3 Q You may answer.
 4 A At the point in time when we began a relationship
 5 with USF&G, certainly I would have communicated to Bruce
 6 though I probably wouldn't have had to because by that point
 7 in time we had been doing audited statements for a number
 8 years and so it really wasn't anything to change other than
 9 who was going to get it.
 10 Q All right. And that was discussed with Bruce,
 11 Bruce Brown?
 12 MS. CARSON: Object to the form.
 13 THE WITNESS: Well I certainly would have
 14 informed him of a change in any -- who we were using for
 15 bonding company standpoint; so to that extent he would have
 16 been aware of who was going to get it.
 17 BY MR. McGLYNN:
 18 Q Did you hire Mr. Brown -- strike that. Did you
 19 ever discuss with Mr. Brown specifically about his knowledge
 20 of construction contracting auditing?
 21 A I'm sure back at the point in time when I went
 22 from a review to that I would have talked to him about it,
 23 although probably by that point in time I was comfortable
 24 enough with Bruce's work product that I probably wouldn't
 25 have really questioned it I guess at that point in time.

Page

1 Q Did you ever have any discussions with Mr.
 2 Diminiani concerning the importance of having an auditor
 3 CCI that was experienced in construction auditing?
 4 A Specifically, no, there was never any question in
 5 terms of the quality of the audit that was done. Dave
 6 Diminiani never expressed any reservations relative to the
 7 work product from Bruce's company.
 8 Q Did Mr. Diminiani know Bruce Brown other than
 9 connection with the audit work that his firm was providing
 10 to CCI?
 11 A I don't know. I mean I know he knows Bruce
 12 Brown. They're both CPAs, so they certainly knew each
 13 other. They may have had other businesses that they both
 14 consulted to, but beyond ours, I really don't know.
 15 Q Now, sir, you -- as part of CCI's relationship
 16 with USF&G, you and other entities were required to execute
 17 a master surety agreement, correct?
 18 A That's about right.
 19 Q Is that a copy of it?
 20 A It looks like one.
 21 Q Does your signature appear on there at all,
 22 either individually or on behalf of any other entity?
 23 A I think it appears here as the president of an
 24 entity as well as individually.
 25 MR. McGLYNN: Why don't we have that marked as

CCI CONSTRUCTION COMPANY, INC.

CONTRACTS-IN-PROGRESS

DECEMBER 31, 1997

Job number	Project	Total contract price	Estimated total direct contract costs	Estimated total contract (loss) before indirect costs	Estimated total contract (loss) before indirect costs	Insertion to December 31, 1997	December 31, 1997	Year ended December 31, 1997	Gross profit (loss) before indirect costs
439	U.E.P.H. Complex	\$ 18,961,072	\$ 16,948,701	\$ 2,012,321	\$ 15,878,479	(3)	\$ 16,899,942	\$ 17,256,553	\$ 1,834,422
445	Mahany Prison	10,289,145	10,523,784	(234,619)	6,308,222		6,337,295	6,074,803	(234,619)
448	Houtzdale Prison	10,357,787	10,440,743	(82,956)	4,169,371		4,349,670	4,096,415	(82,956)
449	Oriskany Pointe	4,804,000	4,328,590	275,410	521,254		509,198	554,419	33,165
450	U.E.P.H. Headquarters	1,397,866	1,374,859	12,907	515,339		473,383	520,139	4,800
451	Johnstown	3,268,800	3,237,111	29,489	115,461		116,513	116,513	1,052
	Lord Fairfax	8,860,893	6,391,795	489,208	411,608		599,088	443,111	31,503
		\$ 55,747,213	\$ 53,245,533	\$ 2,501,680	\$ 27,920,734		\$ 28,168,579	\$ 28,051,753	\$ 1,587,367
							\$ 1,072,281	\$ 681,924	\$ 27,464,395
							\$ 1,072,281	\$ 681,924	\$ 1,587,367

USFG/BS 0438

CCI CONSTRUCTION COMPANY, INC.

CONTRACTS-IN-PROGRESS

DECEMBER 31, 1998

Job Number	Project	Inception to December 31, 1998			December 31, 1998			Year ended December 31, 1998		
		Total contract price	Estimated total direct contract costs	Estimated total contract earnings before indirect costs	Direct contract costs to December 31, 1998	Contract earnings accrued to December 31, 1998 before indirect costs	Billings to December 31, 1998	Revenues earned	Direct cost of revenues earned	Gross profit before indirect costs
418	Capitol Sprinkler	\$ 7,315,964	\$ 5,566,247	\$ 1,749,717	\$ 5,271,160	\$ 1,656,958	\$ 8,718,258	\$ 5,320,584	\$ 3,868,043	\$ 1,452,541
420	Capitol HVAC	298,050	223,180	74,870	92,420	31,004	181,022	123,424	92,420	31,004
421	Capitol Electrical	1,944,846	1,414,085	530,561	1,286,482	482,685	1,601,364	1,769,167	1,286,482	482,685
422	Home Depot	5,040,379	4,802,670	137,709	4,034,072	113,311	4,562,418	4,147,363	4,034,072	113,311
425	Capitol Senate	90,557	67,821	22,736	34,345	11,514	57,220	45,859	34,345	11,514
426	U. S. P. H. Complex	18,430,763	14,763,976	1,646,787	458,348	50,832	551,817	507,180	458,348	50,832
		<u>\$ 31,120,359</u>	<u>\$ 26,957,978</u>	<u>\$ 4,167,380</u>	<u>\$ 11,174,827</u>	<u>\$ 2,346,304</u>	<u>\$ 13,651,099</u>	<u>\$ 11,913,597</u>	<u>\$ 9,771,710</u>	<u>\$ 2,141,887</u>

USFG/BS 0418

CCI CONSTRUCTION COMPANY, INC.

CONTRACTS-IN-PROGRESS

DECEMBER 31, 1995

Job number	Project	Inception to December 31, 1995				Year ended December 31, 1995			
		Total contract price	Estimated total direct contract costs	Estimated total contract earnings (losses) before indirect costs	Direct contract costs to December 31, 1995	Contract earnings (losses) accrued to December 31, 1995 before indirect costs	Costs and estimated earnings (losses) in excess of billings	Billings in excess of costs and estimated earnings (losses)	Gross profit (loss) before indirect costs
208	National Cancer Institute	\$ 13,981,128	\$ 13,521,869	\$ 459,257	\$ 12,227,944	\$ 415,310	\$ 80,249	\$ 58,917	\$ 5,884,108
304	Uniclin University	13,481,321	13,754,517	(293,196)	8,914,508	(293,196)			7,888,028
311	Ugthner Road Elementary School	5,888,739	6,379,578	(510,837)	6,314,158	(510,837)		59,420	3,514,956
329	Consolidation RDT&E	15,381,515	14,833,120	748,395	12,255,498	628,794		50,615	11,329,085
338	N. W. Houston	110,000	70,534	39,466	35,547	19,890		54,563	35,547
339	Mid-America	188,784	138,887	47,897	108,243	37,329		41,212	108,243
381	Cleefield Hospital	4,878,147	4,848,647	229,500	4,044,087	199,652	40,683		2,598,803
384	State College Area Middle School	12,201,283	11,572,882	628,381	11,531,714	628,148	4,359		5,713,273
385	Carlisle Hospital	3,030,894	2,857,872	173,022	2,548,440	154,288		8,961	2,574,801
414	Kaufmann's	3,973,184	3,885,107	288,077	3,433,228	288,387		3,141	3,433,228
418	Capital Sprinkler	5,898,000	5,148,000	750,000	1,403,117	204,417	654,364		1,403,117
		\$ 78,970,973	\$ 78,411,011	\$ 2,559,962	\$ 82,818,492	\$ 1,748,180	\$ 759,655	\$ 278,829	\$ 45,158,899
									\$ 43,814,461
									\$ 1,344,438

BY 00733

CCI CONSTRUCTION COMPANY, INC.

CONTRACTS-IN-PROGRESS

DECEMBER 31, 1998

Job number	Project	Total contract price	Estimated total direct contract costs	Estimated total contract earnings (loss) before indirect costs	Inception to December 31, 1998	December 31, 1998	Year ended December 31, 1998	Gross profit (loss) before indirect costs
					Contract earnings (loss) accrued to December 31, 1998	Costs and earnings in excess of estimated billings	Revenues earned	Direct cost of revenues earned
					December 31, 1998	December 31, 1998		
439	Mahanoy Prison	\$ 11,699,418	\$ 10,687,972	\$ 1,031,446	\$ 1,031,333	\$ 1,216,401	\$ 5,623,543	\$ 4,357,596
450	Johnstown	3,266,600	3,245,082	21,518	7,776	449,618	1,064,029	1,057,305
451	Lord Fairfax	7,082,984	7,301,111	(218,127)	(218,127)	\$ 128,611	5,998,748	6,248,376
454	Albemarle Prison	14,524,840	12,875,751	1,649,089	617,292	717,560	5,438,988	4,819,694
455	Perry Point	12,937,341	11,463,840	1,473,501	608,547	2,234,503	5,343,039	4,734,492
456	Outlook - Hilliard	5,390,745	4,801,310	579,435	327,877	310,268	3,042,870	2,715,193
457	Camp Hill	1,495,629	1,372,273	123,356	49,197	21,307	596,492	547,295
459	Scott Air Force Base	14,870,150	13,929,350	940,800	407,040	138,290	6,433,615	6,076,575
460	Germ Plasma Center	15,565,000	14,667,024	897,976	177,917	831,756	3,083,912	2,905,995
461	Outlook - Chesterfield	3,842,372	3,629,824	212,548	88,902	509,709	1,607,153	1,518,251
462	Outlook - Westerville	5,589,900	5,218,140	371,760	32,669	71,711	491,222	458,553
		<u>\$ 96,254,979</u>	<u>\$ 89,171,677</u>	<u>\$ 7,083,302</u>	<u>\$ 3,130,223</u>	<u>\$ 6,341,726</u>	<u>\$ 38,721,607</u>	<u>\$ 35,389,315</u>
								<u>\$ 3,332,292</u>

USFG/BS 0459

20

CCI CONSTRUCTION COMPANY, INC.

YEARS ENDED
DECEMBER 31, 1996 AND 1995

USFG/BS 0398

BROWN
SCHULTZ
SNYDER
PLESIC
CERTIFIED PUBLIC ACCOUNTANTS
A Professional Corporation

BROWN
SCHULTZ
SNYDER
PLESIC

Independent Auditors' Report

Board of Directors
CCI Construction Company, Inc.
Mechanicsburg, Pennsylvania

We have audited the accompanying balance sheets of CCI Construction Company, Inc. as of December 31, 1996 and 1995 and the related statements of income, shareholder's equity and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of CCI Construction Company, Inc. as of December 31, 1996 and 1995 and the results of its operations and its cash flows for the years then ended, in conformity with generally accepted accounting principles.

Our audits of the financial statements were made for the purpose of forming an opinion on the basic financial statements taken as a whole. The accompanying information is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Brown Schultz Snyder & Plesic

February 12, 1997

USFG/BS 0399

CCI CONSTRUCTION COMPANY, INC.

BALANCE SHEETS - DECEMBER 31, 1996 AND 1995

	1996	1995
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 3,346,115	\$ 2,238,057
Investments in marketable securities	1,803,677	2,541,970
Accounts receivable, trade:		
Shareholder	268,583	
Affiliates	9,570	24,774
Other customers:		
Current	2,606,101	4,419,308
Retained	954,777	1,630,553
Note receivable	31,689	
Costs and estimated earnings in excess of billings on uncompleted contracts	379,663	759,655
Prepaid expenses	53,232	104,041
Total current assets	<u>9,453,407</u>	<u>11,718,358</u>
Property and equipment:		
Automobiles and trucks	279,361	298,142
Furniture	654,220	665,216
Leasehold improvements	3,558	88,161
Machinery and equipment	187,559	184,684
Small tools	11,124	11,124
	<u>1,135,822</u>	<u>1,247,327</u>
Less accumulated depreciation	<u>956,849</u>	<u>929,279</u>
	<u>178,973</u>	<u>318,048</u>
	<u>\$ 9,632,380</u>	<u>\$ 12,036,406</u>

See notes to financial statements.

USFG/BS 0400

LIABILITIES AND SHAREHOLDER'S EQUITY

	<u>1996</u>	<u>1995</u>
Current liabilities:		
Accounts payable, trade:	\$ 2,300	\$ 2,300
Affiliates		
Other vendors:	2,777,935	4,285,641
Current	1,232,823	2,838,191
Retained	278,159	103,348
Accrued expenses	10,857	28,368
Taxes withheld and accrued		
Billings in excess of costs and estimated earnings on uncompleted contracts	509,631	276,829
	<u>4,811,705</u>	<u>7,534,677</u>
Total liabilities (all current)		
Shareholder's equity:		
Common stock, \$1 par, 1,000 shares authorized;	39	39
39 shares issued and outstanding	9,758	9,758
Capital in excess of par	4,768,011	4,465,253
Retained earnings	42,867	26,679
Unrealized gain on marketable securities		
	<u>4,820,675</u>	<u>4,501,729</u>
	<u>\$ 9,632,380</u>	<u>\$ 12,036,406</u>

USFG/BS 0401

CCI CONSTRUCTION COMPANY, INC.

STATEMENTS OF INCOME

YEARS ENDED DECEMBER 31, 1996 AND 1995

	<u>1996</u>	<u>1995</u>
Revenue, construction contracts	\$ 24,465,870	\$ 48,181,072
Cost of contracts	<u>23,146,686</u>	<u>47,208,857</u>
Gross profit	1,319,184	972,215
General and administrative expenses	<u>1,180,087</u>	<u>1,280,577</u>
Income (loss) from operations	<u>139,097</u>	<u>(308,362)</u>
Other income (expense):		
Investment	275,016	335,065
Miscellaneous	17,210	19,864
Gain (loss) on sale of:		
Property and equipment	(72,051)	(770)
Marketable securities	<u>3,852</u>	<u>57,413</u>
	<u>224,027</u>	<u>411,572</u>
Net income	<u>\$ 363,124</u>	<u>\$ 103,210</u>

USFG/BS 0402

See notes to financial statements.

CCI CONSTRUCTION COMPANY, INC.

STATEMENTS OF SHAREHOLDER'S EQUITY

YEARS ENDED DECEMBER 31, 1996 AND 1995

	Shares of common stock	Capital in excess of par	Retained earnings	Unrealized gain (loss) on marketable securities	Total
Balance, December 31, 1994	\$ 39	\$ 7,857	\$ 4,362,043	\$ (79,603)	\$ 4,290,336
Net income		1,901	103,210		103,210
Contributions				106,282	106,282
Unrealized gain on marketable securities				26,679	4,501,729
Balance, December 31, 1995	39	9,758	4,465,253		363,124
Net income			(60,366)		(60,366)
Distributions				16,188	16,188
Unrealized gain on marketable securities				\$ 42,867	\$ 4,820,675
Balance, December 31, 1996	\$ 39	\$ 9,758	\$ 4,768,011		\$ 4,820,675

See notes to financial statements. ✓

USFG/BS 0403

CCI CONSTRUCTION COMPANY, INC.

STATEMENTS OF CASH FLOWS

YEARS ENDED DECEMBER 31, 1996 AND 1995

	<u>1996</u>	<u>1995</u>
Cash flows from operating activities:		
Net income	<u>\$ 363,124</u>	<u>\$ 103,210</u>
Adjustments:		
Depreciation	96,945	132,782
(Gain) loss on sale of:		
Property and equipment	72,051	770
Marketable securities	(186)	(36,671)
(Increase) decrease in:		
Marketable securities	80,000	49,250
Accounts receivable	2,235,604	1,864,507
Costs and estimated earnings in excess of billings on uncompleted contracts	379,992	(476,877)
Prepaid expenses	50,809	(7,943)
Increase (decrease) in:		
Accounts payable	(3,113,074)	(666,218)
Accrued expenses	174,811	(231,759)
Taxes withheld and accrued	(17,511)	5,799
Billings in excess of costs and estimated earnings on uncompleted contracts	<u>232,802</u>	<u>(3,227,035)</u>
Total adjustments	<u>192,243</u>	<u>(2,593,395)</u>
Net cash provided by (used in) operating activities	<u>555,367</u>	<u>(2,490,185)</u>
Cash flows from investing activities:		
Purchase of investments	(100,681)	(842,552)
Proceeds from sale and maturities of investments	775,348	1,052,595
Due from shareholder		13,594
Issuance of note receivable	(35,000)	
Repayment of note receivable	3,311	
Purchase of property and equipment	(37,196)	(32,312)
Proceeds from sale of property and equipment	<u>7,275</u>	<u>23,996</u>
Net cash provided by investing activities	<u>613,057</u>	<u>215,321</u>

(continued)

USFG/BS 0404

CCI CONSTRUCTION COMPANY, INC.

STATEMENTS OF CASH FLOWS (CONTINUED)

YEARS ENDED DECEMBER 31, 1996 AND 1995

	<u>1996</u>	<u>1995</u>
Cash flows from financing activities:		
Contributions from shareholder	<u>\$ (60,366)</u>	<u>\$ 1,901</u>
Distributions to shareholder		
Net cash provided by (used in) financing activities	<u>(60,366)</u>	<u>1,901</u>
Net increase (decrease) in cash and cash equivalents	1,108,058	(2,272,963)
Cash and cash equivalents, beginning of year	<u>2,238,057</u>	<u>4,511,020</u>
Cash and cash equivalents, end of year	<u>\$ 3,346,115</u>	<u>\$ 2,238,057</u>
Supplemental disclosure of cash flow information:		
Cash paid during the year for interest	\$ 1,462	\$ 3,977
Noncash activities:		
Net unrealized gain on marketable securities	16,188	106,282
(see statements of shareholder's equity)		

USFG/BS 0405

See notes to financial statements.

CCI CONSTRUCTION COMPANY, INC.

NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 1996 AND 1995

1. Summary of significant accounting policies:

Form of business:

Effective January 1, 1995, the Company re-established itself as a Pennsylvania corporation and as of that date changed its name from CCI Construction Co. to CCI Construction Company, Inc.

Operations and operating cycle:

The Company constructs commercial buildings primarily under fixed-price contracts in the northeast United States. The Company's receivables are concentrated among customers in this geographic area. The Company extends credit to its customers and generally requires no collateral.

The length of the Company's contracts varies but is typically between one to two years. In accordance with normal practice in the construction industry, the Company includes asset and liability accounts relating to construction contracts in current assets and liabilities even when such amounts are realizable or payable over a period in excess of one year.

Use of estimates:

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Revenue and cost recognition:

Revenues from construction contracts are recognized on the percentage-of-completion method, measured by the percentage of direct cost incurred to date to estimated total direct cost for each contract. That method is used because management considers total cost to be the best available measure of progress on the contracts. Because of inherent uncertainties in estimating costs, it is at least reasonably possible that the estimates used will change within the near term.

USFG/BS 0406

CCI CONSTRUCTION COMPANY, INC.

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

YEARS ENDED DECEMBER 31, 1996 AND 1995

I. Summary of significant accounting policies (continued):

Revenue and cost recognition (continued):

Contract costs include all direct material, labor and subcontracting costs and other direct costs related to contract performance. Indirect costs and general and administrative costs are charged to expense as incurred. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are first determined. Changes in job performance, job conditions and estimated profitability may result in revisions to costs and income and are recognized in the period in which the revisions are determined. An amount equal to contract costs attributable to claims is included in revenues when realization is probable and the amount can be reliably estimated.

The asset, "Costs and estimated earnings in excess of billings on uncompleted contracts," represents revenues recognized in excess of amounts billed. The liability, "Billings in excess of costs and estimated earnings on uncompleted contracts," represents billings in excess of revenues recognized.

Cash and cash equivalents:

For purposes of reporting cash flows, the Company considers all highly liquid debt instruments purchased with a maturity of three months or less to be cash equivalents.

Marketable securities:

Marketable securities consist of debt and equity securities.

The Company has adopted Statement of Financial Accounting Standards No. 115, Accounting for Certain Investments in Debt and Equity Securities. This statement addresses the accounting and reporting for investments in equity securities that have readily determinable fair values and for all investments in debt securities. Those investments are to be classified in three categories and accounted for as follows:

- Debt securities that the enterprise has the positive intent and ability to hold to maturity are classified as held-to-maturity securities and reported at amortized cost.
- Debt and equity securities that are bought and held principally for the purpose of selling in the near term are classified as trading securities and reported at fair value, with unrealized gains and losses included in earnings.

USFG/BS 0407

CCI CONSTRUCTION COMPANY, INC.

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

YEARS ENDED DECEMBER 31, 1996 AND 1995

1. Summary of significant accounting policies (continued):

Marketable securities (continued):

- Debt and equity securities not classified as either held-to-maturity securities or trading securities are classified as available-for sale securities and reported at fair value, with unrealized gains and losses excluded from earnings and reported in a separate component of stockholder's equity. Fair value of the marketable securities is based on quoted market prices for those or similar securities or quotes from brokers.

Gains and losses are determined using the specific identification method when securities are sold.

Property and equipment:

Property and equipment are stated at cost. Depreciation is provided using an accelerated method over the estimated useful lives of the assets.

Reclassification:

Certain 1995 amounts have been reclassified to conform with 1996 classifications.

2. Cash and cash equivalents:

Cash and cash equivalents consist of the following:

	<u>1996</u>	<u>1995</u>
Cash	\$ 792,232	\$(506,611)
Certificates of deposit	191,723	638,805
Money market funds	887,014	1,020,034
Repurchase agreements	<u>1,475,146</u>	<u>1,085,829</u>
	<u>\$ 3,346,115</u>	<u>\$ 2,238,057</u>

The amount of deposits in cash held at the bank exceeded the Federal Deposit Insurance Corporation (FDIC) by \$984,523. The certificates of deposit and money market funds held by brokers and the repurchase agreements are not insured by the FDIC. The repurchase agreements sold by a bank were held in custody by this bank for the account of CCI Construction Company, Inc. and were invested in securities.

CCI CONSTRUCTION COMPANY, INC.

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

YEARS ENDED DECEMBER 31, 1996 AND 1995

3. Marketable securities:

The cost or amortized cost and the aggregate fair value of investments in the debt and equity securities at December 31, 1996 and 1995 are as follows:

	1996				1995			
	Cost or amortized cost	Gross unrealized losses	Gross unrealized gains	Estimated fair value	Cost or amortized cost	Gross unrealized losses	Gross unrealized gains	Estimated fair value
Trading securities, corporate equity securities					\$ 100,000	\$ 20,000		\$ 80,000
Available-for-sale securities:								
Mutual funds	\$ 1,482,961	\$ 11,387	\$ 66,313	\$ 1,537,887	1,675,109		\$ 39,214	1,714,323
Obligations of states and political subdivisions	<u>277,849</u>	<u>12,059</u>		<u>265,790</u>	<u>760,182</u>	<u>12,535</u>		<u>747,647</u>
	<u>\$ 1,760,810</u>	<u>\$ 23,446</u>	<u>\$ 66,313</u>	<u>\$ 1,803,677</u>	<u>\$ 2,535,291</u>	<u>\$ 32,535</u>	<u>\$ 39,214</u>	<u>\$ 2,541,970</u>

USFG/BS 0409

CCI CONSTRUCTION COMPANY, INC.

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

YEARS ENDED DECEMBER 31, 1996 AND 1995

3. Marketable securities (continued):

During 1995, the Company sold securities classified as held-to-maturity with an amortized cost of \$702,679 for a gain of \$35,502. On December 31, 1995, the Company transferred the held-to-maturity securities remaining at that date which had an amortized cost of \$760,182 and an unrealized gain of \$12,535 to the available-for-sale category due to a change of intent to hold these securities until maturity.

The amortized cost and estimated fair value of available-for-sale debt securities at December 31, 1996 by contractual maturity are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized cost	Estimated fair value
Due after ten years	<u>\$ 277,849</u>	<u>\$ 265,790</u>
Available-for-sale securities:		
	<u>1996</u>	<u>1995</u>
Cost of securities sold	\$ 775,162	\$ 313,245
Proceeds from sale	775,347	314,116
Gross realized gains	12,047	5,318
Gross realized losses	11,862	4,447

Realized gains of \$513 on trading securities were included in the net income for 1996 and unrealized gains of \$3,000 on these securities were included in the net income for 1995.

USFG/BS 0410

CCI CONSTRUCTION COMPANY, INC.

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

YEARS ENDED DECEMBER 31, 1996 AND 1995

4. Uncompleted contracts:

	<u>1996</u>	<u>1995</u>
Contract costs	\$ 11,174,827	\$ 62,816,462
Estimated earnings thereon	<u>2,346,304</u>	<u>1,748,180</u>
	13,521,131	64,564,642
Less billings applicable thereto	<u>13,651,099</u>	<u>64,081,816</u>
	<u><u>\$ (129,968)</u></u>	<u><u>\$ 482,826</u></u>
Included in the balance sheet as:		
Costs and estimated earnings in excess of billings on uncompleted contracts	\$ 379,663	\$ 759,655
Billings in excess of costs and estimated earnings on uncompleted contracts	<u>(509,631)</u>	<u>(276,829)</u>
	<u><u>\$ (129,968)</u></u>	<u><u>\$ 482,826</u></u>

5. Line of credit:

The Company has available a \$1,000,000 unsecured line of credit expiring on April 30, 1997 which requires interest at the bank's prime rate. The Company has no outstanding balance on the line at December 31, 1996.

6. Rent expense:

Various equipment and operating facilities are leased under noncancelable agreements. Total rent expense for all leases, including the related party lease discussed in Note 7, was \$120,623 and \$177,186 in 1996 and 1995, respectively.

USFG/BS 0411

CCI CONSTRUCTION COMPANY, INC.

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

YEARS ENDED DECEMBER 31, 1996 AND 1995

6. Rent expense (continued):

The aggregate minimum rental commitments under all noncancelable leases at December 31, 1996 are as follows:

<u>Year ending December 31,</u>	<u>Amount</u>
1997	\$ 72,233
1998	<u>11,784</u>
	<u>\$ 84,017</u>

7. Related party transactions:

The Company leased an operating facility from a related party, Old Gettysburg Associates II through November 30, 1996. The sole shareholder of the Company has a 20% partnership interest in Old Gettysburg Associates II. Total rent expense relating to this facility for 1996 and 1995 was \$71,864 and \$97,335, respectively.

Effective December 1, 1996, the Company began leasing an operating facility owned by its sole shareholder on a year-to-year basis. The lease requires an annual rental payment of \$45,000. Rent expense for this facility was \$3,750 for 1996. At December 31, 1996, the sole shareholder was billed \$268,270 for costs incurred by the Company relating to renovations made to the operating facility noted above.

8. Income taxes:

No provision has been made for federal income taxes and certain state income taxes. Under a provision of the Internal Revenue Code and the Commonwealth of Pennsylvania Tax Act, and the revenue codes of certain states, the Company has elected not to be taxed as a corporation and the sole shareholder has consented to include the income in his individual return. Taxes have been provided on income earned in states that do not recognize these tax provisions.

USFG/BS 0412

CCI CONSTRUCTION COMPANY, INC.

COST OF CONTRACTS

YEARS ENDED DECEMBER 31, 1996 AND 1995

	<u>1996</u>	<u>1995</u>
Direct costs:		
Labor	\$ 1,726,413	\$ 1,805,825
Payroll taxes	183,327	191,852
Employee benefits	207,848	74,384
Equipment rental	7,437	23,371
Materials	2,031,948	2,505,759
Other	753,330	1,514,061
Subcontractors	17,773,935	40,267,339
Temporary help		54,907
	<u>22,684,238</u>	<u>46,437,498</u>
Indirect costs:		
Salaries	174,179	488,820
Payroll taxes	19,727	45,197
Employee benefits	13,044	34,176
Blueprints	703	7,925
Depreciation	28,576	46,645
Dues and permits	293	595
Employee recruitment	1,702	4,439
Insurance	1,718	1,555
Miscellaneous	706	1,932
Office supplies and expense	2,515	16,622
Postage	1,790	6,237
Professional services	131,915	1,425
Rent	36,360	60,765
Repairs and maintenance	4,324	3,096
Safety	128	1,186
Telephone	16,446	23,210
Temporary help	581	4,037

USFG/BS 0413

(continued)

CCI CONSTRUCTION COMPANY, INC.

COST OF CONTRACTS (CONTINUED)

YEARS ENDED DECEMBER 31, 1996 AND 1995

	<u>1996</u>	<u>1995</u>
Indirect costs (continued):		
Trade books and journals	\$ 89	\$ 387
Training and seminars	122	
Travel and entertainment	440	14,118
Utilities	2,014	2,678
Warehouse expenses	776	1,015
Warranty service	<u>24,300</u>	<u>5,299</u>
	<u>462,448</u>	<u>771,359</u>
Total cost of contracts	<u>\$ 23,146,686</u>	<u>\$ 47,208,857</u>

USFG/BS 0414

CCI CONSTRUCTION COMPANY, INC.

GENERAL AND ADMINISTRATIVE EXPENSES

YEARS ENDED DECEMBER 31, 1996 AND 1995

	<u>1996</u>	<u>1995</u>
Salaries:	\$ 271,680	\$ 215,480
Officers	399,009	395,996
Office	46,920	52,615
Payroll taxes		
Employee:	38,686	55,052
Benefits	322	106
Recruitment	1,746	2,800
Advertising	3,273	4,536
Bank charges	4,712	8,790
Blueprints	855	7,272
Company sponsored activities	2,298	5,340
Contributions	68,369	86,137
Depreciation	8,150	7,251
Dues	15,148	17,714
Insurance	46,230	72,830
Licenses and taxes	268	204
Miscellaneous	11,099	6,363
Office supplies	9,305	13,338
Postage	98,874	161,453
Professional services	45,930	57,671
Rent	11,582	10,920
Repairs and maintenance	59,435	58,236
Telephone		444
Temporary help	20,809	15,054
Trade books and journals	4,257	937
Training and seminars	9,737	24,038
Travel and entertainment	1,393	
Utilities		
	<u>\$ 1,180,087</u>	<u>\$ 1,280,577</u>
Total general and administrative expenses		

USFG/BS 0415

CCI CONSTRUCTION COMPANY, INC.

EARNINGS FROM CONTRACTS

YEAR ENDED DECEMBER 31, 1996

	<u>Revenues earned</u>	<u>Cost of revenues earned</u>	<u>Gross profit (loss)</u>
Contracts completed during the year	\$ 12,093,252	\$ 12,408,317 (a)	\$ (315,065)
Contracts-in-progress at year-end	11,913,597	9,771,710 (a)	2,141,887
Construction management contracts	175,357	225,490 (a)	(50,133)
Time and material jobs	<u>283,664</u>	<u>278,721</u> (a)	<u>4,943</u>
	24,465,870	22,684,238	1,781,632
Indirect costs	<u> </u>	<u>462,448</u>	<u>462,448</u>
	<u>\$ 24,465,870</u>	<u>\$ 23,146,686</u>	<u>\$ 1,319,184</u>

(a) Excludes indirect costs not allocated to specific jobs.

USFG/BS 0416

CCI CONSTRUCTION COMPANY, INC.

COMPLETED CONTRACTS

YEAR ENDED DECEMBER 31, 1996

Job number	Contract	Contract totals			Before January 1, 1996			During the year ended December 31, 1996		
		Revenues earned	Cost of revenues earned	Gross profit (loss) before indirect costs	Revenues earned	Cost of revenues earned	Gross profit (loss) before indirect costs	Revenues earned	Cost of revenues earned	Gross profit (loss) before indirect costs
206	National Cancer Institute	\$ 14,546,469	\$ 14,124,022	\$ 422,447	\$ 12,643,254	\$ 12,227,944	\$ 415,310	\$ 1,803,215	\$ 1,896,078	\$ 7,137
304	Lincoln University	13,713,429	14,436,461	(723,032)	8,621,312	8,914,508	(293,196)	5,092,117	5,521,953	(429,836) (1)
311	Lightner Road Elementary School	5,855,100	6,461,083	(626,983)	5,803,321	6,314,158	(510,837)	51,779	168,925	(115,146) (1)
329	Consolidated RDT&E	15,708,691	15,016,387	692,504	12,882,292	12,255,498	626,794	2,826,599	2,760,869	65,730
338	N.W. Houston	110,000	48,669	63,331	55,437	35,547	19,890	54,563	11,122	43,441
339	Mid-America	186,784	127,464	59,320	145,572	108,243	37,329	41,212	19,221	21,991
381	Clearfield Hospital	4,966,370	4,724,210	242,160	4,243,719	4,044,067	199,652	722,651	680,143	42,508
384	State College Area Middle School	12,141,747	11,504,638	637,109	12,157,860	11,531,714	626,146	(16,113)	27,076	10,963
385	Carlisle Hospital	3,003,664	2,799,792	203,872	2,702,726	2,548,440	154,286	300,936	251,352	49,584
414	Kaufmann's	3,973,184	3,699,655	273,529	3,701,613	3,433,226	268,387	271,571	266,429	5,142
417	Villa Teresa	949,281	825,661	123,620	267,059	107,766	159,293	682,222	717,895	(35,673) (2)
423	Capital Cafeteria	68,000	60,289	7,711				68,000	60,289	7,711
427	EPWI	94,500	83,097	11,403				94,500	83,097	11,403
		\$ 75,317,419	\$ 73,929,428	\$ 1,387,991	\$ 63,224,167	\$ 61,521,111	\$ 1,703,056	\$ 12,093,252	\$ 12,408,317	\$ (315,065)

(1) The loss incurred in 1996 was caused by additional costs associated with subcontractor defaults and the related legal expenses to defend those cases which were unforeseen at December 31, 1995.

(2) Construction management contract at December 31, 1995.

USFG/BS 0417

CCI CONSTRUCTION COMPANY, INC.

CONTRACTS-IN-PROGRESS

DECEMBER 31, 1998

Job number	Project	Inception to December 31, 1998				December 31, 1998		Year ended December 31, 1998			
		Total contract price	Estimated total direct contract costs	Estimated total contract earnings before indirect costs	Direct contract costs to December 31, 1998	Contract earnings accrued to December 31, 1998 before indirect costs	Billings to December 31, 1998	Costs and estimated earnings in excess of billings	Revenues earned	Direct cost of revenues earned	Gross profit before indirect costs
418	Capitol Sprinkler	\$ 7,315,964	\$ 5,568,247	\$ 1,749,717	\$ 5,271,160	\$ 1,650,958	\$ 6,716,258	\$ 211,860	\$ 5,320,584	\$ 3,868,043	\$ 1,452,541
420	Capitol HVAC	288,050	223,180	74,870	92,420	31,004	181,922	\$ 38,498	123,424	92,420	31,004
421	Capitol Electrical	1,944,646	1,414,085	530,561	1,286,482	482,685	1,601,364	167,803	1,769,167	1,286,482	482,685
422	Home Depot	5,040,378	4,902,670	137,709	4,034,072	113,311	4,582,418	415,035	4,147,383	4,034,072	113,311
425	Capitol Senate	90,557	67,821	22,736	34,345	11,514	57,220	11,381	45,859	34,345	11,514
426	U.E.P.H. Complex	16,430,753	14,783,978	1,646,787	458,348	50,832	551,917	44,737	507,180	458,348	50,832
		<u>\$ 31,120,358</u>	<u>\$ 28,957,978</u>	<u>\$ 4,167,380</u>	<u>\$ 11,114,827</u>	<u>\$ 2,346,304</u>	<u>\$ 13,651,099</u>	<u>\$ 379,663</u>	<u>\$ 11,913,597</u>	<u>\$ 9,771,710</u>	<u>\$ 2,141,887</u>

USFG/BS 0418

3

CCI CONSTRUCTION COMPANY, INC.

**YEARS ENDED
DECEMBER 31, 1997 AND 1996**

USFG/BS 0419

CCI CONSTRUCTION COMPANY, INC.

YEARS ENDED DECEMBER 31, 1997 AND 1996

CONTENTS

	Page
Independent auditors' report	1
Financial statements:	
Balance sheets	2
Statements of income	3
Statements of shareholder's equity	4
Statements of cash flows	5-6
Notes to financial statements	7-11
Accompanying information to financial statements:	
Cost of contracts	12-13
General and administrative expenses	14
Earnings from contracts	15
Completed contracts	16
Contracts-in-progress	17

USFG/BS 0420



Independent Auditors' Report

Board of Directors
CCI Construction Company, Inc.
Mechanicsburg, Pennsylvania

We have audited the accompanying balance sheets of CCI Construction Company, Inc. as of December 31, 1997 and 1996 and the related statements of income, shareholder's equity and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of CCI Construction Company, Inc. as of December 31, 1997 and 1996 and the results of its operations and its cash flows for the years then ended, in conformity with generally accepted accounting principles.

Our audits of the financial statements were made for the purpose of forming an opinion on the basic financial statements taken as a whole. The accompanying information is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Brown Schultz

February 10, 1998

USFG/BS 0421

CERTIFIED PUBLIC ACCOUNTANTS
AND
BUSINESS ADVISORS

A PROFESSIONAL CORPORATION

1811 MUMMA ROAD
WORMLEYSBURG, PA 17041

PO BOX 6784
HARRISBURG, PA 17106-784
717-761-717
PA: 800-294-734
FAX: 717-737-665

2501 OREGON PIKE
SUITE THREE
LANCASTER, PA 17601
717-560-831
FAX: 717-560-87

CCI CONSTRUCTION COMPANY, INC.

BALANCE SHEETS - DECEMBER 31, 1997 AND 1996

	1997	1996
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 1,128,337	\$ 3,346,115
Investments in marketable securities	3,702,992	1,803,677
Accounts receivable, trade:		
Customers:		
Current	8,230,674	2,606,101
Retained	1,121,610	954,777
Shareholder		268,583
Affiliates	3,485	9,570
Note receivable	22,569	31,689
Costs and estimated earnings in excess of billings on uncompleted contracts	1,072,281	379,663
Prepaid expenses	6,185	53,232
Shop inventory	639	
Total current assets	<u>15,288,772</u>	<u>9,453,407</u>
Property and equipment:		
Automobiles and trucks	427,342	279,361
Furniture	553,587	654,220
Machinery and equipment	1,323,233	187,559
Other	<u>72,453</u>	<u>14,682</u>
	2,376,615	1,135,822
Less accumulated depreciation	<u>920,919</u>	<u>956,849</u>
	<u>1,455,696</u>	<u>178,973</u>
	<u>\$ 16,744,468</u>	<u>\$ 9,632,380</u>

See notes to financial statements.

USFG/BS 0422

LIABILITIES AND SHAREHOLDER'S EQUITY

	<u>1997</u>	<u>1996</u>
Current liabilities:		
Accounts payable, trade:		
Vendors:		
Current	\$ 7,846,395	\$ 2,777,935
Retained	1,078,950	1,232,823
Affiliates		2,300
Notes payable	815,781	
Accrued expenses	808,601	278,159
Taxes withheld and accrued	58,023	10,857
Billings in excess of costs and estimated earnings on uncompleted contracts	681,924	509,631
	<u>11,289,674</u>	<u>4,811,705</u>
Total liabilities (all current)		
Shareholder's equity:		
Common stock, \$1 par, 1,000 shares authorized;		
39 shares issued and outstanding	39	39
Capital in excess of par	9,758	9,758
Retained earnings	5,208,489	4,768,011
Unrealized gain on marketable securities	<u>236,508</u>	<u>42,867</u>
	<u>5,454,794</u>	<u>4,820,675</u>
	<u>\$ 16,744,468</u>	<u>\$ 9,632,380</u>

USFG/BS 0423

CCI CONSTRUCTION COMPANY, INC.

STATEMENTS OF INCOME

YEARS ENDED DECEMBER 31, 1997 AND 1996

	<u>1997</u>	<u>1996</u>
Revenue	\$ 34,921,676	\$ 24,465,870
Cost of contracts	<u>32,617,473</u>	<u>23,146,686</u>
Gross profit	2,304,203	1,319,184
General and administrative expenses	<u>1,954,380</u>	<u>1,180,087</u>
Income from operations	<u>349,823</u>	<u>139,097</u>
Other income (expense):		
Investment	367,538	275,016
Miscellaneous	(1,546)	17,210
Gain (loss) on sale of:		
Property and equipment	(2,920)	(72,051)
Marketable securities and cash equivalents	<u>(6,016)</u>	<u>3,852</u>
	<u>357,056</u>	<u>224,027</u>
Net income	<u>\$ 706,879</u>	<u>\$ 363,124</u>

USFG/BS 0424

See notes to financial statements.

CCI CONSTRUCTION COMPANY, INC.

STATEMENTS OF SHAREHOLDER'S EQUITY

YEARS ENDED DECEMBER 31, 1997 AND 1996

	Shares of common stock	Capital in excess of par	Retained earnings	Unrealized gain on marketable securities	Total
Balance, December 31, 1995	\$ 39	\$ 9,758	\$ 4,465,253	\$ 26,679	\$ 4,501,729
Net income			363,124		363,124
Distributions			(60,366)	16,188	(60,366)
Unrealized gain on marketable securities				42,867	4,820,675
Balance, December 31, 1996	39	9,758	4,768,011		706,879
Net income			706,879		(266,401)
Distributions			(266,401)	193,641	193,641
Unrealized gain on marketable securities				236,508	\$ 5,454,794
Balance, December 31, 1997	\$ 39	\$ 9,758	\$ 5,208,489	\$ 236,508	\$ 5,454,794

See notes to financial statements.

USFG/BS 0425

CCI CONSTRUCTION COMPANY, INC.

STATEMENTS OF CASH FLOWS

YEARS ENDED DECEMBER 31, 1997 AND 1996

	<u>1997</u>	<u>1996</u>
Cash flows from operating activities:		
Net income	<u>\$ 706,879</u>	<u>\$ 363,124</u>
Adjustments:		
Depreciation	156,504	96,945
(Gain) loss on sale of:		
Property and equipment	2,920	72,051
Marketable securities	6,293	(186)
(Increase) decrease in:		
Marketable securities		80,000
Accounts receivable	(5,516,738)	2,235,604
Costs and estimated earnings in excess of billings on uncompleted contracts	(692,618)	379,992
Prepaid expenses	47,047	50,809
Shop inventory	(-639)	
Increase (decrease) in:		
Accounts payable	4,912,287	(3,113,074)
Accrued expenses	530,442	174,811
Taxes withheld and accrued	47,166	(17,511)
Billings in excess of costs and estimated earnings on uncompleted contracts	<u>172,293</u>	<u>232,802</u>
Total adjustments	<u>(335,043)</u>	<u>192,243</u>
Net cash provided by operating activities	<u>371,836</u>	<u>555,367</u>
Cash flows from investing activities:		
Purchase of investments	(11,093,130)	(100,681)
Proceeds from sale and maturities of investments	9,381,163	775,348
Issuance of note receivable		(35,000)
Repayment of note receivable	9,120	3,311
Purchase of property and equipment	(560,929)	(37,196)
Proceeds from sale of property and equipment	<u>13,864</u>	<u>7,275</u>
Net cash provided by (used in) investing activities	<u>(2,249,912)</u>	<u>613,057</u>

(continued)

USFG/BS 0426

CCI CONSTRUCTION COMPANY, INC.

STATEMENTS OF CASH FLOWS (CONTINUED)

YEARS ENDED DECEMBER 31, 1997 AND 1996

	<u>1997</u>	<u>1996</u>
Cash flows from financing activities:		
Distributions to shareholder	\$(266,401)	\$(60,366)
Repayment of notes payable	(73,301)	
Net cash used in financing activities	(339,702)	(60,366)
Net increase (decrease) in cash and cash equivalents	(2,217,778)	1,108,058
Cash and cash equivalents, beginning of year	<u>3,346,115</u>	<u>2,238,057</u>
Cash and cash equivalents, end of year	<u>\$ 1,128,337</u>	<u>\$ 3,346,115</u>
Supplemental disclosure of cash flow information:		
Cash paid during the year for interest	\$ 1,707	\$ 1,462
Noncash activities:		
Net unrealized gain on marketable securities (see statements of shareholder's equity)	\$ 193,641	16,188
Notes payable totaling \$889,082 were incurred for the acquisition of new equipment		

USFG/BS 0427

See notes to financial statements.

CCI CONSTRUCTION COMPANY, INC.

NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 1997 AND 1996

1. Summary of significant accounting policies:

Operations and operating cycle:

The Company constructs and renovates commercial buildings primarily under fixed-price contracts in the northeast United States. The Company's receivables are concentrated among customers in this geographic area. The Company extends credit to its customers and generally requires no collateral.

The length of the Company's contracts varies but is typically between one to two years. In accordance with normal practice in the construction industry, the Company includes asset and liability accounts relating to construction contracts in current assets and liabilities even when such amounts are realizable or payable over a period in excess of one year.

Use of estimates:

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Revenue and cost recognition:

Revenues from construction contracts are recognized on the percentage-of-completion method, measured by the percentage of direct cost incurred to date to estimated total direct cost for each contract. That method is used because management considers direct cost to be the best available measure of progress on the contracts. Because of inherent uncertainties in estimating costs, it is at least reasonably possible that the estimates used will change within the near term.

For purposes of determining percentage of completion estimates, contract costs include all direct material, labor and subcontracting costs and other direct costs related to contract performance. Indirect costs and general and administrative costs are charged to expense as incurred. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are first determined. Changes in job performance, job conditions and estimated profitability may result in revisions to costs and income and are recognized in the period in which the revisions are determined. An amount equal to contract costs attributable to claims is included in revenues when realization is probable and the amount can be reliably estimated.

CCI CONSTRUCTION COMPANY, INC.

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

YEARS ENDED DECEMBER 31, 1997 AND 1996

1. Summary of significant accounting policies (continued):*Revenue and cost recognition (continued):*

The asset, "Costs and estimated earnings in excess of billings on uncompleted contracts," represents revenues recognized in excess of amounts billed. The liability, "Billings in excess of costs and estimated earnings on uncompleted contracts," represents billings in excess of revenues recognized.

Cash and cash equivalents:

For purposes of reporting cash flows, the Company considers all highly liquid debt instruments purchased with a maturity of three months or less to be cash equivalents.

Marketable securities:

Marketable securities are reported at fair value, with unrealized gains and losses excluded from earnings and reported in a separate component of stockholder's equity. Fair value of the marketable securities is based on quoted market prices for those or similar securities or quotes from brokers. Gains and losses are determined using the specific identification method when securities are sold.

Property and equipment:

Property and equipment are stated at cost. Depreciation is provided using an accelerated method over the estimated useful lives of the assets.

2. Cash and cash equivalents:

Cash and cash equivalents consist of the following:

	<u>1997</u>	<u>1996</u>
Cash	\$ 451	\$ 792,232
Certificates of deposit		191,723
Money market funds	403,714	887,014
Repurchase agreements, net of cash overdraft of \$601,973	<u>724,172</u>	<u>1,475,146</u>
	<u>\$ 1,128,337</u>	<u>\$ 3,346,115</u>

CCI CONSTRUCTION COMPANY, INC.

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

YEARS ENDED DECEMBER 31, 1997 AND 1996

2. Cash and cash equivalents (continued):

At December 31, 1997, the amount of deposits in cash held at the bank exceeded the Federal Deposit Insurance Corporation (FDIC) by \$48,396. The money market funds and the repurchase agreements are not insured by the FDIC. The repurchase agreements sold by a bank were held in custody by this bank for the account of CCI Construction Company, Inc. and were invested in securities, which are not pledged as collateral.

3. Marketable securities:

The cost or amortized cost and the aggregate fair value of investments in the debt and equity securities at December 31, 1997 and 1996 are as follows:

	1997				1996			
	Cost or amortized cost	Gross unrealized losses	Gross unrealized gains	Estimated fair value	Cost or amortized cost	Gross unrealized losses	Gross unrealized gains	Estimated fair value
Available-for-sale securities:								
Mutual funds	\$ 3,386,480	\$ 16,845	\$ 253,465	\$ 3,623,100	\$ 1,482,961	\$ 11,367	\$ 66,313	\$ 1,537,887
Obligations of states and political subdivisions	80,004	112		79,892	277,849	12,059		265,790
	<u>\$ 3,466,484</u>	<u>\$ 16,957</u>	<u>\$ 253,465</u>	<u>\$ 3,702,992</u>	<u>\$ 1,760,810</u>	<u>\$ 23,446</u>	<u>\$ 66,313</u>	<u>\$ 1,803,677</u>

The available-for-sale debt securities at December 31, 1997 are due after ten years. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

CCI CONSTRUCTION COMPANY, INC.**NOTES TO FINANCIAL STATEMENTS (CONTINUED)****YEARS ENDED DECEMBER 31, 1997 AND 1996****3. Marketable securities (continued):**

	<u>1997</u>	<u>1996</u>
Cost of securities sold	\$ 9,387,456	\$ 775,162
Proceeds from sale	9,381,163	775,347
Gross realized gains		12,047
Gross realized losses	6,293	11,862

4. Uncompleted contracts:

	<u>1997</u>	<u>1996</u>
Contract costs	\$ 27,920,734	\$ 11,174,827
Estimated earnings thereon	<u>1,638,199</u>	<u>2,346,304</u>
	29,558,933	13,521,131
Less billings applicable thereto	<u>29,168,576</u>	<u>13,651,099</u>
	<u>\$ 390,357</u>	<u>\$ (129,968)</u>
Included in the balance sheet as:		
Costs and estimated earnings in excess of billings on uncompleted contracts	\$ 1,072,281	\$ 379,663
Billings in excess of costs and estimated earnings on uncompleted contracts	<u>(681,924)</u>	<u>(509,631)</u>
	<u>\$ 390,357</u>	<u>\$ (129,968)</u>

5. Notes payable:

Equipment is pledged as collateral for these notes which require monthly installments of \$74,600, including interest at 1.27%, through December 1998.

6. Line of credit:

The Company has available a \$1,000,000 unsecured line of credit expiring on April 30, 1998 which requires interest at the bank's prime rate. The Company has no outstanding balance on the line at December 31, 1997.

CCI CONSTRUCTION COMPANY, INC.**NOTES TO FINANCIAL STATEMENTS (CONTINUED)****YEARS ENDED DECEMBER 31, 1997 AND 1996****7. Rent expense:**

Various equipment and operating facilities are leased under noncancelable agreements. Total rent expense for all leases, including the related party lease discussed in Note 8, was \$432,492 and \$120,623 in 1997 and 1996, respectively.

The aggregate minimum rental commitments under all noncancelable leases at December 31, 1997 are as follows:

<u>Year ending</u> <u>December 31,</u>	<u>Amount</u>
1998	\$ 95,796
1999	21,730

8. Related party transactions:

The Company leased an operating facility from a related party, Old Gettysburg Associates II through November 30, 1996. The sole shareholder of the Company has a 20% partnership interest in Old Gettysburg Associates II. Total rent expense relating to this facility for 1996 was \$71,864.

Effective December 1, 1996, the Company began leasing an operating facility owned by its sole shareholder on a year-to-year basis. The lease requires an annual rental payment of \$45,000. Rent expense for this facility was \$45,000 and \$3,750 for 1997 and 1996, respectively. At December 31, 1996, the sole shareholder was billed \$268,270 for costs incurred by the Company relating to renovations made to this operating facility. This balance was paid in 1997.

During 1997, the Company incurred warranty insurance expense of \$825,000 with Pennsylvania Contractors Insurance Company, a corporation under common control. These costs are allocated as direct cost of contracts.

9. Income taxes:

No provision has been made for federal or state income taxes. Under provisions of the Internal Revenue Code and the Commonwealth of Pennsylvania Tax Act, the Company has elected not to be taxed as a corporation and the sole shareholder has consented to include the income in his individual return.

USFG/BS 0432

CCI CONSTRUCTION COMPANY, INC.

COST OF CONTRACTS

YEARS ENDED DECEMBER 31, 1997 AND 1996

	<u>1997</u>	<u>1996</u>
Direct costs:		
Labor	\$ 2,886,054	\$ 1,726,413
Payroll taxes	335,936	183,327
Employee benefits	677,477	207,848
Equipment	41,373	
Equipment rental	381,924	7,437
Materials	4,259,253	2,031,948
Other	1,679,129	753,330
Subcontractors	<u>22,099,706</u>	<u>17,773,935</u>
	<u>32,360,852</u>	<u>22,684,238</u>
Indirect costs:		
Salaries	86,208	174,179
Payroll taxes	11,217	19,727
Employee benefits	8,324	13,044
Blueprints	6	703
Depreciation	95,723	28,576
Dues and permits	710	293
Employee recruitment	7,151	1,702
Insurance	716	1,718
Miscellaneous		706
Office supplies and expense	8,112	2,515
Postage	253	1,790
Professional services		131,915
Rent	8,636	36,360
Repairs and maintenance	3,648	4,324
Safety	2,157	128
Telephone	11,802	16,446
Temporary help		581

USFG/BS 0433

(continued)

CCI CONSTRUCTION COMPANY, INC.

COST OF CONTRACTS (CONTINUED)

YEARS ENDED DECEMBER 31, 1997 AND 1996

	<u>1997</u>	<u>1996</u>
Indirect costs (continued):		
Trade books and journals	\$ 556	\$ 89
Training and seminars		122
Travel and entertainment	728	440
Utilities	1,413	2,014
Warehouse expenses	9,261	776
Warranty service		<u>24,300</u>
	<u>256,621</u>	<u>462,448</u>
Total cost of contracts	<u>\$ 32,617,473</u>	<u>\$ 23,146,686</u>

USFG/BS 0434

CCI CONSTRUCTION COMPANY, INC.

GENERAL AND ADMINISTRATIVE EXPENSES

YEARS ENDED DECEMBER 31, 1997 AND 1996

	<u>1997</u>	<u>1996</u>
Salaries:	\$ 1,038,273	\$ 271,680
Officers	410,023	399,009
Office	73,399	46,920
Payroll taxes		
Employee:	33,722	38,686
Benefits	2,237	322
Recruitment	1,038	1,746
Advertising	3,667	3,273
Bank charges	13,507	4,712
Blueprints	1,098	855
Company sponsored activities	3,030	2,298
Contributions	60,781	68,369
Depreciation	8,058	8,150
Dues	12,162	15,148
Insurance	44,270	46,230
Licenses and taxes	265	268
Miscellaneous	18,875	11,099
Office supplies	7,914	9,305
Postage	95,337	98,874
Professional services	33,744	45,930
Rent	7,689	11,582
Repairs and maintenance	31,328	59,435
Telephone	22,995	20,809
Trade books and journals	1,086	4,257
Training and seminars	5,948	9,737
Travel and entertainment	23,934	1,393
Utilities		
Total general and administrative expenses	<u>\$ 1,954,380</u>	<u>\$ 1,180,087</u>

USFG/BS 0435

CCI CONSTRUCTION COMPANY, INC.

EARNINGS FROM CONTRACTS

YEAR ENDED DECEMBER 31, 1997

	<u>Revenues earned</u>	<u>Cost of revenues earned</u>	<u>Gross profit</u>
Contracts completed during the year	\$ 4,940,855	\$ 4,076,410 (a)	\$ 864,445
Contracts-in-progress at year-end	29,051,753	27,464,386 (a)	1,587,367
Construction management contracts	45,890	31,325 (a)	14,565
Time and material jobs	<u>883,178</u>	<u>788,731</u> (a)	<u>94,447</u>
	34,921,676	32,360,852	2,560,824
Indirect costs	<u> </u>	<u>256,621</u>	<u>256,621</u>
	<u>\$ 34,921,676</u>	<u>\$ 32,617,473</u>	<u>\$ 2,304,203</u>

(a) Excludes indirect costs not allocated to specific jobs.

USFG/BS 0436

CCI CONSTRUCTION COMPANY, INC.

COMPLETED CONTRACTS

YEAR ENDED DECEMBER 31, 1997

Job number	Contract	Contract totals			Before January 1, 1997			During the year ended December 31, 1997		
		Revenues earned	Cost of revenues earned	Gross profit before indirect costs	Revenues earned	Cost of revenues earned	Gross profit before indirect costs	Revenues earned	Cost of revenues earned	Gross profit before indirect costs
418	Capital Sprinkler - A	\$ 7,808,776	\$ 5,935,487	\$ 1,873,309	\$ 6,928,118	\$ 5,271,160	\$ 1,656,958	\$ 880,658	\$ 684,307	\$ 216,351
420	Capital HVAC	204,058	103,588	100,470	123,424	92,420	31,004	80,634	11,168	69,466
421	Capital Electrical	2,460,065	1,729,583	730,482	1,769,167	1,286,482	482,685	690,898	443,101	247,797
422	Home Depot	5,200,440	5,034,557	165,883	4,147,383	4,034,072	113,311	1,053,057	1,000,485	52,572
425	Capital Senate	93,741	47,294	46,447	45,859	34,345	11,514	47,882	12,849	34,933
436	Capital Sprinkler - H	191,714	178,131	13,583				191,714	178,131	13,583
437	Capital renovation	1,290,074	1,149,938	140,136				1,290,074	1,149,938	140,136
442	Capital porticoes	705,938	616,331	89,607				705,938	616,331	89,607
		<u>\$ 17,954,806</u>	<u>\$ 14,794,889</u>	<u>\$ 3,159,917</u>	<u>\$ 13,013,951</u>	<u>\$ 10,719,479</u>	<u>\$ 2,295,472</u>	<u>\$ 4,940,855</u>	<u>\$ 4,078,410</u>	<u>\$ 884,445</u>

USFG/BS 0437

CCI CONSTRUCTION COMPANY, INC.

CONTRACTS-IN-PROGRESS

DECEMBER 31, 1997

Job number	Project	Total contract price	Estimated total direct contract costs	Estimated total contract earnings (loss) before indirect costs	Direct contract costs to December 31, 1997	Inception to December 31, 1997 Contract earnings (loss) accrued to December 31, 1997 before indirect costs	December 31, 1997 Costs and earnings in excess of billings	December 31, 1997 Billings in excess of costs and estimated earnings	Year ended December 31, 1997 Revenues earned	Year ended December 31, 1997 Direct cost of revenues earned	Gross profit (loss) before indirect costs
439	U.E.P.H. Complex	\$ 18,961,022	\$ 16,948,701	\$ 2,012,321	\$ 15,878,479	\$ 1,885,254	\$ 863,791	\$ 267,692	\$ 17,256,553	\$ 15,422,131	\$ 1,834,422
445	Mahany Prison	10,286,145	10,523,764	(234,619)	6,309,222	(234,619)	6,309,222	6,309,222	6,309,222	4,169,371	(234,619)
448	Hautzelle Prison	10,357,787	10,440,743	(82,956)	4,169,371	(82,956)	4,169,371	263,255	4,086,415	521,254	33,165
449	Outlook Pointe	4,604,000	4,328,590	275,410	521,254	33,165	45,221	45,221	534,419	515,339	4,800
450	U.E.P.H. Headquarters	1,387,666	1,374,859	12,807	515,339	4,800	46,756	46,756	520,139	515,339	4,800
451	Johnstown	3,268,600	3,237,111	29,489	115,461	1,052	116,513	116,513	116,513	115,461	1,052
	Lord Fairfax	9,890,893	6,391,765	489,208	411,608	31,503	116,513	155,877	443,111	411,608	31,503
		\$ 55,747,213	\$ 53,245,553	\$ 2,501,660	\$ 27,920,734	\$ 1,638,199	\$ 1,072,281	\$ 681,924	\$ 29,051,753	\$ 27,484,386	\$ 1,567,367

USFG/BS 0438

3

CCI CONSTRUCTION COMPANY, INC.

YEARS ENDED
DECEMBER 31, 1998 AND 1997

USFG/BS 0439

CCI CONSTRUCTION COMPANY, INC.
YEARS ENDED DECEMBER 31, 1998 AND 1997

CONTENTS

	Page
Independent auditors' report	1
Financial statements:	
Balance sheets	2
Statements of income	3
Statements of shareholder's equity	4-5
Statements of cash flows	6-7
Notes to financial statements	8-13
Accompanying information to financial statements:	
Cost of contracts	14
General and administrative expenses	15
Earnings from contracts	16
Completed contracts	17
Contracts-in-progress	18



Independent Auditors' Report

Board of Directors
CCI Construction Company, Inc.
Mechanicsburg, Pennsylvania

We have audited the accompanying balance sheets of CCI Construction Company, Inc. as of December 31, 1998 and 1997 and the related statements of income, shareholder's equity and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of CCI Construction Company, Inc. as of December 31, 1998 and 1997 and the results of its operations and its cash flows for the years then ended, in conformity with generally accepted accounting principles.

Our audits of the financial statements were made for the purpose of forming an opinion on the basic financial statements taken as a whole. The accompanying information is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Brown Schultz Sheridan & Fritz

February 10, 1999

USFG/BS 0441

CERTIFIED PUBLIC ACCOUNTANTS
AND
BUSINESS ADVISORS

A PROFESSIONAL CORPORATION

1011 MILANNA ROAD
WORMLENSBURG, PA 17043

PO BOX 5766
HARRISBURG, PA 17105-7666
717 737-7171
PA 800 294-7330
FAX 717 737-0622

1725 OREGON AVE
LANCASTER, PA 17602
717 860-8078
PA 800 294-7330
FAX 717 860-8078

WEBSITE: WWW.BSFCOM

CCI CONSTRUCTION COMPANY, INC.

BALANCE SHEETS - DECEMBER 31, 1998 AND 1997

ASSETS

	1998	1997
Current assets:		
Cash and cash equivalents	\$ 2,429,866	\$ 1,128,337
Investments in marketable securities	631,481	3,702,992
Accounts receivable, trade:		
Customers:		
Current	5,964,311	8,230,674
Retained	1,822,224	1,121,610
Affiliates	365,756	3,485
Note receivable		22,569
Costs and estimated earnings in excess of billings on uncompleted contracts	6,341,726	1,072,281
Prepaid expenses	170,232	6,185
Shop inventory	38,161	639
Total current assets	<u>17,763,757</u>	<u>15,288,772</u>
Property and equipment:		
Automobiles and trucks	1,269,567	427,342
Furniture	851,738	553,587
Machinery and equipment	5,947,290	1,323,233
Other	344,128	72,453
	8,412,723	2,376,615
Less accumulated depreciation	<u>1,651,485</u>	<u>920,919</u>
	<u>6,761,238</u>	<u>1,455,696</u>
Other assets:		
Cash surrender value of officer's life insurance	55,453	
Investments	<u>34,000</u>	
	<u>89,453</u>	
	<u>\$ 24,614,448</u>	<u>\$ 16,744,468</u>

See notes to financial statements.

USFG/BS 0442

LIABILITIES AND SHAREHOLDER'S EQUITY

	<u>1998</u>	<u>1997</u>
Current liabilities:		
Accounts payable, trade:		
Current	\$ 10,974,274	\$ 7,846,395
Retained	2,180,967	1,078,950
Notes payable	1,338,280	815,781
Current portion of long-term debt	333,060	808,601
Accrued expenses	91,601	58,023
Taxes withheld and accrued		
Billings in excess of costs and estimated earnings on uncompleted contracts	288,208	681,924
	<u>15,206,390</u>	<u>11,289,674</u>
Total current liabilities		
Long-term debt, net of current portion	<u>4,164,375</u>	
Total liabilities	<u>19,370,765</u>	<u>11,289,674</u>
Shareholder's equity:		
Common stock, \$1 par, 1,000 shares authorized;		
39 shares issued and outstanding	39	39
Capital in excess of par	9,758	9,758
Retained earnings	5,254,834	5,208,489
Accumulated other comprehensive income (loss),		
unrealized gain (loss) on marketable securities	(20,948)	236,508
	<u>5,243,683</u>	<u>5,454,794</u>
	<u>\$ 24,614,448</u>	<u>\$ 16,744,468</u>

CCI CONSTRUCTION COMPANY, INC.

STATEMENTS OF INCOME

YEARS ENDED DECEMBER 31, 1998 AND 1997

	<u>1998</u>	<u>1997</u>
Revenue	\$ 52,534,453	\$ 34,921,676
Cost of contracts	<u>51,145,382</u>	<u>32,617,473</u>
Gross profit	1,389,071	2,304,203
General and administrative expenses	<u>1,505,700</u>	<u>1,954,380</u>
Income (loss) from operations	<u>(116,629)</u>	<u>349,823</u>
Other income (expense):		
Gain (loss) on sale of:		
Marketable securities and cash equivalents	260,927	(6,016)
Property and equipment	10,069	(2,920)
Interest	(161,296)	
Investment	151,592	367,538
Miscellaneous	<u>(85,622)</u>	<u>(1,546)</u>
	<u>175,670</u>	<u>357,056</u>
Net income	<u>\$ 59,041</u>	<u>\$ 706,879</u>

USFG/BS 0444

See notes to financial statements.

CCI CONSTRUCTION COMPANY, INC.

STATEMENTS OF SHAREHOLDER'S EQUITY

YEARS ENDED DECEMBER 31, 1998 AND 1997

	Common stock	Capital in excess of par	Retained earnings	Accumulated other comprehensive income (loss)	Total
Balance, December 31, 1996	\$ 39	\$ 9,758	\$ 4,768,011	\$ 42,867	\$ 4,820,675
Comprehensive income:			706,879		706,879
Net income					
Other comprehensive income:					
Unrealized holding gains arising during the period				187,348	187,348
on marketable securities				6,293	6,293
Add reclassification adjustment					193,641
					900,520
Comprehensive income			(266,401)		(266,401)
Distributions					
	39	9,758	5,208,489	236,508	5,454,794
Balance, December 31, 1997 (carried forward)					

(continued)

USFG/BS 0445

CCI CONSTRUCTION COMPANY, INC.

STATEMENTS OF SHAREHOLDER'S EQUITY (CONTINUED)

YEARS ENDED DECEMBER 31, 1998 AND 1997

	Common stock	Capital in excess of par	Retained earnings	Accumulated other comprehensive income (loss)	Total
Balance, December 31, 1997 (brought forward)	\$ 39	\$ 9,758	\$ 5,208,489	\$ 236,508	\$ 5,454,794
Comprehensive loss:			59,041		59,041
Net income					
Other comprehensive income (loss):					
Unrealized holding gains arising during the period				3,469	3,469
on marketable securities				(260,925)	(260,925)
Less reclassification adjustment					
				(257,456)	(257,456)
				(198,415)	(198,415)
Comprehensive loss			(12,696)		(12,696)
Distributions					
Balance, December 31, 1998	\$ 39	\$ 9,758	\$ 5,254,834	\$ (20,948)	\$ 5,243,683

USFG/BS 0446

See notes to financial statements.

CCI CONSTRUCTION COMPANY, INC.

STATEMENTS OF CASH FLOWS

YEARS ENDED DECEMBER 31, 1998 AND 1997

	<u>1998</u>	<u>1997</u>
Cash flows from operating activities:		
Net income	\$ 59,041	\$ 706,879
Adjustments:		
Depreciation	793,014	156,504
(Gain) loss on sale of:		
Property and equipment	(10,069)	2,920
Marketable securities	(260,927)	6,293
(Increase) decrease in:		
Accounts receivable	1,203,478	(5,516,738)
Costs and estimated earnings in excess of billings on uncompleted contracts	(5,269,445)	(692,618)
Prepaid expenses	(164,047)	47,047
Shop inventory	(37,522)	(639)
Cash surrender value of officer's life insurance	(55,453)	
Increase (decrease) in:		
Accounts payable	4,229,896	4,912,287
Accrued expenses	(475,541)	530,442
Taxes withheld and accrued	33,578	47,166
Billings in excess of costs and estimated earnings on uncompleted contracts	(393,716)	172,293
Total adjustments	(406,754)	(335,043)
Net cash provided by (used in) operating activities	(347,713)	371,836
Cash flows from investing activities:		
Purchase of:		
Investments	(161,670)	(11,093,130)
Property and equipment	(98,793)	(560,929)
Repayment of note receivable	22,569	9,120
Proceeds from:		
Sale and maturities of investments	3,202,652	9,381,163
Sale of property and equipment	28,502	13,864
Net cash provided by (used in) investing activities	2,993,260	(2,249,912)

(continued)

USFG/BS 0447

CCI CONSTRUCTION COMPANY, INC.

STATEMENTS OF CASH FLOWS (CONTINUED)

YEARS ENDED DECEMBER 31, 1998 AND 1997

	<u>1998</u>	<u>1997</u>
Cash flows from financing activities:		
Distributions to shareholder	\$(12,696)	\$(266,401)
Proceeds from issuance of notes payable and long-term debt	17,990,666	
Repayment of notes payable and long-term debt	<u>(19,321,988)</u>	<u>(73,301)</u>
Net cash used in financing activities	<u>(1,344,018)</u>	<u>(339,702)</u>
Net increase (decrease) in cash and cash equivalents	1,301,529	(2,217,778)
Cash and cash equivalents, beginning of year	<u>1,128,337</u>	<u>3,346,115</u>
Cash and cash equivalents, end of year	<u>\$ 2,429,866</u>	<u>\$ 1,128,337</u>
Supplemental disclosure of cash flow information:		
Cash paid during the year for interest	\$ 161,296	\$ 1,707
Noncash activities:		
Net increase (decrease) in unrealized gain on marketable securities (see statements of shareholder's equity)	\$(257,456)	\$ 193,641
Notes payable incurred for the acquisition of new equipment	\$ 6,018,196	\$ 889,082

USFG/BS 0448

See notes to financial statements.

CCI CONSTRUCTION COMPANY, INC.

NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 1998 AND 1997

1. Summary of significant accounting policies:

Operations and operating cycle:

The Company constructs and renovates commercial buildings primarily under fixed-price contracts in the eastern United States. The Company's receivables are concentrated among customers in this geographic area. The Company extends credit to its customers and generally requires no collateral.

The length of the Company's contracts varies but is typically between one to two years. In accordance with normal practice in the construction industry, the Company includes asset and liability accounts relating to construction contracts in current assets and liabilities even when such amounts are realizable or payable over a period in excess of one year.

Use of estimates:

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Revenue and cost recognition:

Revenues from construction contracts are recognized on the percentage-of-completion method, measured by the percentage of direct cost incurred to date to estimated total direct cost for each contract. That method is used because management considers direct cost to be the best available measure of progress on the contracts. Because of inherent uncertainties in estimating costs, it is at least reasonably possible that the estimates used will change within the near term.

For purposes of determining percentage of completion estimates, contract costs include all direct material, labor and subcontracting costs and other direct costs related to contract performance. Indirect costs and general and administrative costs are charged to expense as incurred. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are first determined. Changes in job performance, job conditions and estimated profitability may result in revisions to costs and income and are recognized in the period in which the revisions are determined. An amount equal to contract costs attributable to claims is included in revenues when realization is probable and the amount can be reliably estimated.

USFG/BS 0449

CCI CONSTRUCTION COMPANY, INC.

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

YEARS ENDED DECEMBER 31, 1998 AND 1997

1. Summary of significant accounting policies (continued):

Revenue and cost recognition (continued):

The asset, "Costs and estimated earnings in excess of billings on uncompleted contracts," represents revenues recognized in excess of amounts billed. The liability, "Billings in excess of costs and estimated earnings on uncompleted contracts," represents billings in excess of revenues recognized.

Cash and cash equivalents:

For purposes of reporting cash flows, the Company considers all highly liquid debt instruments purchased with a maturity of three months or less to be cash equivalents.

Marketable securities:

Marketable securities are reported at fair value, with unrealized gains and losses excluded from earnings and reported in a separate component of stockholder's equity. Fair value of the marketable securities is based on quoted market prices for those or similar securities or quotes from brokers. Gains and losses are determined using the specific identification method when securities are sold.

Property and equipment:

Property and equipment are stated at cost. Depreciation is provided using straight-line and accelerated methods over the estimated useful lives of the assets.

Change in presentation:

During 1998, the Company adopted Statement of Financial Accounting Standards No. 130, Reporting Comprehensive Income (SFAS No. 130). SFAS No. 130 requires the reporting of comprehensive income in addition to net income from operations. Comprehensive income is a more inclusive financial reporting methodology that includes disclosure of certain financial information that historically has not been recognized in the calculation of net income. SFAS No. 130 requires that the earlier year provided for comparative purposes be reclassified to conform to the statement.

USFG/BS 0450

CCI CONSTRUCTION COMPANY, INC.

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

YEARS ENDED DECEMBER 31, 1998 AND 1997

2. Cash and cash equivalents:

Cash and cash equivalents consist of the following:

	1998	1997
Cash	\$ 374,464	\$ 451
Money market funds	1,035	403,714
Repurchase agreements	<u>2,054,367</u>	<u>724,172</u>
	<u>\$ 2,429,866</u>	<u>\$ 1,128,337</u>

At December 31, 1998, the amount of deposits in cash held at the bank exceeded the Federal Deposit Insurance Corporation (FDIC) insurance by \$867,883. The money market funds and the repurchase agreements are not insured by the FDIC. The repurchase agreements sold by a bank were held in custody by this bank for the account of CCI Construction Company, Inc. and were invested in securities, which are not pledged as collateral.

3. Marketable securities:

The cost or amortized cost and the aggregate fair value of investments in the debt and equity securities at December 31, 1998 and 1997 are as follows:

	1998		
	Cost or amortized cost	Gross unrealized losses	Estimated fair value
Available-for-sale securities, mutual funds	<u>\$ 652,429</u>	<u>\$ 20,948</u>	<u>\$ 631,481</u>

	1997			
	Cost or amortized cost	Gross unrealized losses	Gross unrealized gains	Estimated fair value
Available-for-sale securities:				
Mutual funds	\$ 3,386,480	\$ 16,845	\$ 253,465	\$ 3,623,100
Obligations of states and political subdivisions	<u>80,004</u>	<u>112</u>		<u>79,892</u>
	<u>\$ 3,466,484</u>	<u>\$ 16,957</u>	<u>\$ 253,465</u>	<u>\$ 3,702,992</u>

CCI CONSTRUCTION COMPANY, INC.

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

YEARS ENDED DECEMBER 31, 1998 AND 1997

3. Marketable securities (continued):

	<u>1998</u>	<u>1997</u>
Cost of securities sold	\$ 2,941,725	\$ 9,387,456
Proceeds from sale	3,202,652	9,381,163
Gross realized gains	262,391	
Gross realized losses	1,464	6,293

4. Uncompleted contracts:

	<u>1998</u>	<u>1997</u>
Contract costs	\$ 42,225,606	\$ 27,920,734
Estimated earnings thereon	<u>3,130,223</u>	<u>1,638,199</u>
	45,355,829	29,558,933
Less billings applicable thereto	<u>39,302,311</u>	<u>29,168,576</u>
	<u>\$ 6,053,518</u>	<u>\$ 390,357</u>
Included in the balance sheet as:		
Costs and estimated earnings in excess of billings on uncompleted contracts	\$ 6,341,726	\$ 1,072,281
Billings in excess of costs and estimated earnings on uncompleted contracts	<u>(288,208)</u>	<u>(681,924)</u>
	<u>\$ 6,053,518</u>	<u>\$ 390,357</u>

5. Long-term debt:

Long-term debt consists of the following:

	<u>1998</u>
Obligations to various financing corporations due in current monthly installments totaling \$116,074, including interest at fixed rates approximating 7%. The notes, which are secured by the financed equipment, mature at various dates through August 2003.	\$ 3,964,581

CCI CONSTRUCTION COMPANY, INC.

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

YEARS ENDED DECEMBER 31, 1998 AND 1997

5. Long-term debt (continued):

	<u>1998</u>
Borrowings under a \$2,000,000 bank equipment line of credit are secured by the financed equipment. The agreement requires the December 31, 1998 balance to be repaid by December 2003 in monthly installments of \$30,238, including interest at a fixed rate of 6.7%.	<u>\$ 1,538,074</u>
Total long-term debt	5,502,655
Less current portion	<u>1,338,280</u>
Long-term debt portion	<u>\$ 4,164,375</u>

Aggregate principal payments due on long-term debt for the five years subsequent to December 31, 1998 are as follows:

1999	\$ 1,338,280
2000	1,415,424
2001	1,242,569
2002	961,559
2003	<u>544,823</u>
	<u>\$ 5,502,655</u>

6. Operating line of credit:

The Company has available a \$2,000,000 unsecured operating line of credit expiring on April 30, 1999 which requires interest at the bank's prime rate less 1/2%. The Company has no outstanding balance on the line at December 31, 1998.

7. Rent expense:

Various equipment and operating facilities are leased under noncancellable agreements. Total rent expense for all leases, including the related party lease discussed in Note 8, was \$1,689,666 and \$432,492 in 1998 and 1997, respectively.

The aggregate minimum rental commitments under all noncancellable leases at December 31, 1998 totaling \$28,639 are due in 1999.

CCI CONSTRUCTION COMPANY, INC.

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

YEARS ENDED DECEMBER 31, 1998 AND 1997

8. Related party transactions:

The Company is leasing an operating facility owned by its sole shareholder through March 31, 1999. The lease requires a monthly rental payment of \$4,037. Rent expense for this facility was \$48,444 and \$45,000 for 1998 and 1997, respectively.

Effective April 1, 1999, the Company will begin leasing an operating facility from Mechanicsburg Land Company, which is owned by the Company's sole shareholder, on a year-to-year basis. The initial lease, which expires December 31, 1999, requires monthly lease payments of \$14,329. Additionally, the Company entered into a contract for the construction of this facility with Mechanicsburg Land Company. Billings of \$339,203 were included in accounts receivable as of December 31, 1998.

During 1997, the Company incurred warranty insurance expense of \$825,000 with Pennsylvania Contractors Insurance Company, a corporation under common control. These costs are allocated as direct cost of contracts. There were no such costs in 1998.

During 1998, two insurance claims for contract losses incurred of \$900,000 were paid by Pennsylvania Contractors Insurance Company. These claims were covered under the terms of a remedial work period insurance policy.

In addition, Pennsylvania Contractors Insurance Company has guaranteed a claim of \$1,162,460 filed by the Company with a contract owner. If the owner fails to pay all or any part of this claim, the insurance company will pay the unpaid portion.

9. Income taxes:

No provision has been made for federal or state income taxes. Under provisions of the Internal Revenue Code and the Commonwealth of Pennsylvania Tax Act, the Company has elected not to be taxed as a corporation and the sole shareholder has consented to include the income in his individual return.

10. Year 2000 issues:

Like any other company, advances and changes in available technology can significantly affect the business and operations of the Company. A challenging problem exists as many computer systems worldwide do not have the capability of recognizing the year 2000 or years thereafter. No easy technology "quick fix" has yet been developed for this problem. While the Company has not requested verification of its year 2000 status from its auditors, it believes its computer systems will effectively deal with transactions in the year 2000 and beyond. This "Year 2000 Computer Problem" creates risk for the Company from unforeseen problems from third parties with whom the Company deals on financial transactions. Failures of the third parties' computer systems could have an impact to the Company's ability to conduct its business. The effect, if any, is unknown at this time.

CCI CONSTRUCTION COMPANY, INC.

COST OF CONTRACTS

YEARS ENDED DECEMBER 31, 1998 AND 1997

	<u>1998</u>	<u>1997</u>
Direct costs:		
Labor	\$ 6,457,982	\$ 2,886,054
Payroll taxes	702,129	335,936
Employee benefits	667,597	677,477
Equipment	111,207	41,373
Equipment rental	1,625,224	381,924
Materials	10,371,108	4,259,253
Other	1,745,316	1,679,129
Subcontractors	<u>27,802,562</u>	<u>22,099,706</u>
	<u>49,483,125</u>	<u>32,360,852</u>
Indirect costs:		
Salaries	528,517	86,208
Payroll taxes	61,224	11,217
Employee benefits	70,560	8,324
Blueprints	163	6
Depreciation	687,512	95,723
Dues and permits	5,340	710
Employee recruitment	44,621	7,151
Insurance	4,486	716
Office supplies and expense	53,393	8,112
Postage	2,187	253
Professional services	37,338	
Rent	40,731	8,636
Repairs and maintenance	12,655	3,648
Safety	2,732	2,157
Telephone	28,926	11,802
Temporary help	7,591	
Trade books and journals	1,892	556
Training and seminars	8,303	
Travel and entertainment	10,290	728
Utilities	10,397	1,413
Warehouse expenses	<u>43,399</u>	<u>9,261</u>
	<u>1,662,257</u>	<u>256,621</u>
Total cost of contracts	<u>\$ 51,145,382</u>	<u>\$ 32,617,473</u>

CCI CONSTRUCTION COMPANY, INC.

GENERAL AND ADMINISTRATIVE EXPENSES

YEARS ENDED DECEMBER 31, 1998 AND 1997

	1998	1997
Salaries:		
Officers	\$ 353,939	\$ 1,038,273
Office	480,807	410,023
Payroll taxes	60,247	73,399
Employee:		
Benefits	53,857	33,722
Recruitment	4,379	2,237
Advertising	3,067	1,038
Bad debt	22,569	
Bank charges	5,111	3,667
Blueprints	17,551	13,507
Company sponsored activities	2,373	1,098
Contributions	14,220	3,030
Depreciation	105,502	60,781
Dues	16,335	8,058
Insurance	12,399	12,162
Licenses and taxes	44,559	44,270
Miscellaneous		265
Office supplies	50,617	18,875
Postage	8,967	7,914
Professional services	109,543	95,337
Rent	23,711	33,744
Repairs and maintenance	6,555	7,689
Telephone	19,164	31,328
Temporary help	1,719	
Trade books and journals	24,222	22,995
Training and seminars	5,938	1,086
Travel and entertainment	30,687	5,948
Utilities	27,662	23,934
Total general and administrative expenses	<u>\$ 1,505,700</u>	<u>\$ 1,954,380</u>

USFG/BS 0456

CCI CONSTRUCTION COMPANY, INC.

EARNINGS FROM CONTRACTS

YEAR ENDED DECEMBER 31, 1998

	Revenues earned	Cost of revenues earned	Gross profit (loss)
Contracts completed during the year	\$ 13,541,950	\$ 13,969,824 (a)	\$ (427,874)
Contracts-in-progress at year-end	38,721,607	35,389,315 (a)	3,332,292
Construction management contracts	83,777	20,444 (a)	63,333
Time and material jobs	<u>187,119</u>	<u>103,542</u> (a)	<u>83,577</u>
	52,534,453	49,483,125	3,051,328
Indirect costs	<u> </u>	<u>1,662,257</u>	<u>(1,662,257)</u>
	<u>\$ 52,534,453</u>	<u>\$ 51,145,382</u>	<u>\$ 1,389,071</u>

(a) Excludes indirect costs not allocated to specific jobs.

USFG/BS 0457

CCI CONSTRUCTION COMPANY, INC.

COMPLETED CONTRACTS

YEAR ENDED DECEMBER 31, 1998

Job number	Contract	Contract totals			Before January 1, 1998			During the year ended December 31, 1998		
		Revenues earned	Cost of revenues earned	Gross profit (loss) before indirect costs	Revenues earned	Cost of revenues earned	Gross profit before indirect costs	Revenues earned	Cost of revenues earned	Gross profit (loss) before indirect costs
426	U.E.P.H. Complex	\$ 19,272,256	\$ 17,479,889	\$ 1,792,367	\$ 17,763,732	\$ 15,878,479	\$ 1,885,253	\$ 1,508,524	\$ 1,601,410	\$ (92,886)
445	Houtzdale Prison	10,937,202	11,397,234	(460,032)	4,086,420	4,169,371	(82,951)	6,850,782	7,227,863	(377,081)
448	Outlook Creekview	4,800,644	4,655,443	145,201	554,419	521,254	33,165	4,246,225	4,134,189	112,036
449	U.E.P.H. Headquarters	1,456,558	1,521,701	(65,143)	520,139	515,339	4,800	938,419	1,006,362	(69,943)
		<u>\$ 36,468,660</u>	<u>\$ 35,054,267</u>	<u>\$ 1,412,393</u>	<u>\$ 22,924,710</u>	<u>\$ 21,084,443</u>	<u>\$ 1,840,267</u>	<u>\$ 13,541,950</u>	<u>\$ 13,969,824</u>	<u>\$ (427,874)</u>

USFG/BS 0458

CCI CONSTRUCTION COMPANY, INC.

CONTRACTS-IN-PROGRESS

DECEMBER 31, 1998

Job number	Project	Inception to December 31, 1998				December 31, 1998		Year ended December 31, 1998			
		Total contract price	Estimated total direct contract costs	Estimated total contract earnings (loss) before indirect costs	Direct contract costs to December 31, 1998	Contract earnings (loss) accrued to December 31, 1998 before indirect costs	Billings to December 31, 1998	Costs and estimated earnings in excess of billings	Billings in excess of costs and estimated earnings	Revenues earned	Direct cost of revenues earned
439	Mahanoy Prison	\$ 11,699,418	\$ 10,667,972	\$ 1,031,446	\$ 10,666,808	\$ 1,031,333	\$ 10,481,740	\$ 1,216,401	\$ 5,623,543	\$ 4,357,566	\$ 1,265,957
450	Johnstown	3,268,600	3,245,082	21,518	1,172,766	7,776	730,724	449,818	1,064,029	1,057,305	6,724
451	Lord Fairfax	7,082,984	7,301,111	(218,127)	6,659,984	(218,127)	6,570,468		5,998,746	6,248,376	(248,630)
454	Albemarle Prison	14,524,840	12,815,751	1,649,089	4,819,694	617,292	4,719,428	717,560	5,438,986	4,819,894	617,292
455	Perry Point	12,937,341	11,463,840	1,473,501	4,734,492	608,547	3,108,536	2,234,503	5,343,039	4,734,492	608,547
456	Outlook - Hilliard	5,380,745	4,801,310	578,435	2,715,193	327,677	2,732,602	310,268	3,042,870	2,715,193	327,677
457	Camp Hill	1,495,629	1,372,273	123,356	547,295	49,197	617,799		598,492	547,295	49,197
459	Scott Air Force Base	14,870,150	13,929,350	940,800	6,026,575	407,040	6,571,905		6,433,615	6,026,575	407,040
460	Germ Plasma Center	15,565,000	14,667,024	897,976	2,905,995	177,917	2,252,156	831,756	3,083,912	2,905,995	177,917
461	Outlook - Chesterfield	3,842,372	3,629,824	212,548	1,518,251	88,902	1,097,444	509,709	1,607,153	1,518,251	88,902
462	Outlook - Westerville	5,589,900	5,218,140	371,760	459,553	32,669	419,511	71,711	491,222	459,553	32,669
		\$ 96,254,979	\$ 89,171,677	\$ 7,083,302	\$ 42,225,606	\$ 3,130,223	\$ 39,302,311	\$ 6,341,726	\$ 38,721,607	\$ 35,389,315	\$ 3,332,292

USFG/BS 0459

35

UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF PENNSYLVANIA
(Harrisburg Division)

UNITED STATES FIDELITY AND
GUARANTY COMPANY,
Plaintiff

v.

BRUCE J. BROWN and
BROWN SCHULTZ SHERIDAN &
FRITZ,
Defendants

CIVIL ACTION NO. 1:01-CV-00813

JUDGE KANE

**DEFENDANT BROWN, SCHULTZ, SHERIDAN & FRITZ'S RESPONSES AND
OBJECTIONS TO UNITED STATES FIDELITY AND GUARANTY COMPANY'S
FIRST REQUEST FOR THE PRODUCTION OF DOCUMENTS**

Defendant, Brown, Schultz, Sheridan & Fritz, by and through its attorneys, hereby responds to United States Fidelity & Guaranty Company's ("USF&G") First Request for Production of Documents, as follows:

GENERAL OBJECTIONS

The following general objections are incorporated by reference into each and every response to plaintiff's requests for production:

1. Defendant objects to these requests to the extent that seek documents which are protected from disclosure by the attorney client privilege and/or the work product doctrine.
2. Defendant objects to the document requests to the extent they go beyond the scope permitted by the Federal Rules of Civil Procedure.

RESPONSE:

Defendant objects to this request as overly broad and as seeking information which is neither relevant nor reasonably calculated to lead to the discovery of admissible evidence.

Subject to and without waiver of its objections, defendant responds that the documents responsive to this request, to the extent they exist, have previously been produced to USF&G

19. All documents relating to completion costs on any CCI projects.

RESPONSE:

Defendant objects to this request as overly broad and as seeking information which is neither relevant nor reasonably calculated to lead to the discovery of admissible evidence.

Subject to and without waiver of its objections, defendant responds that the documents responsive to this request, to the extent they exist, have previously been produced to USF&G

20. All documents relating to Brown Schultz's written procedures for audits used or employed as they relate to the Audit Reports.

RESPONSE:

Defendant objects to this request as vague, ambiguous, overly broad and as seeking information which is neither relevant nor reasonably calculated to lead to the discovery of admissible evidence. Subject to and without waiver of its objections defendant refers plaintiff to the files previously produced to USF&G. In addition, defendant utilizes the Horwath International Audit Manual which will be made available for inspection upon request.

21. All documents relating to the procedures governing internal review of audits employed or used by Brown Schultz.

3

Horwath

Horwath International Audit Manual (U.S. Version) 2000 Edition



to recorded sales), because confirmations cannot be relied upon to test completeness.

12.045 If the types of misstatements found in respondents' and nonrespondents' accounts are significantly different, we should determine whether we discovered misstatements in the confirmation replies that we could not find by performing alternate procedures. If so, and we are unable to obtain confirmation replies from nonrespondents, we should design and perform additional alternate procedures capable of detecting the types of misstatements necessary to achieve our objectives, such as would likely be found in the confirmation replies.

12.046 For example, assume that of the 65 replies, four customers had misstated invoice prices. If alternate procedures included a check of pricing by comparing the prices on nonrespondents' accounts to the correct prices, we may combine the evaluations because all pricing misstatements in the test would have come to our attention. As another example, assume two misstatements in confirmation replies reveal that the customer returned merchandise and no credit was given (and the client agrees that credit is owed to the customer). Alternate procedures such as examination of remittance advices and shipping documents would not cause us to detect this type of misstatements, so we should determine the cause of the misstatements and design another substantive test to search for unrecorded merchandise and determine the extent. In this situation, we might perform a test comparing receiving reports of returned merchandise to credits issued in the subsequent period. If each test is a sample, we may combine the results of the two tests to compute known and projected misstatements.

12.047 For each confirmation request, we should determine an audited amount considering the accumulated evidence. Then we can evaluate the results of the test and determine known and projected misstatements.

12.048 When we evaluate negative and positive confirmations, we usually define as a misstatement a confirmation reply that:

- Cannot be reconciled,
- Is reconciled and the client's records are misstated, or
- Cannot be delivered because the address is incorrect (we might perform alternative procedures to prove the amount exists, but when the client does not have a proper address, consider whether there might be a valuation problem).

In-transit items usually are not misstatements if we are satisfied the items are properly recorded according to shipping terms and documents.

Special Industry Considerations

Construction

12.049 In the construction industry, under percentage-of-completion accounting, revenue and "work-in-process" (unbilled receivables) is recorded before billing and recording accounts receivable. Because we cannot confirm the amount of unbilled receivables with the client's customers, we should design an alternative test of revenue. In this situation, we might test billing and collections in the period after the confirmation date. If unbilled construction receivables is significant, we ordinarily need to evaluate and test the client's method of estimating percentage of completion and costs to complete, including, perhaps,

B. 135

GUARANTY AGREEMENT

This Guaranty Agreement, given on this 1st day of December 1998, by PENNSYLVANIA CONTRACTORS INSURANCE COMPANY ("PCIC") to CCI CONSTRUCTION CO., INC. ("CCI") as follows:

PCIC will guarantee the claim that was filed by CCI, in the amount of One Million Two Hundred Thousand Dollars (\$1,200,000.00), with the Department of General Services, Commonwealth of Pennsylvania, for the project known as Mahanoy State Correctional Institution, Frackville, Pennsylvania. If the Department of General Services, Commonwealth of Pennsylvania, fails to pay all or any part of the subject claim, PCIC will pay the difference owing or the full amount of the claim if no part of the claim is paid.

All rights and liabilities herein given to, or imposed upon, the respective parties hereto shall extend to and bind the several and respective heirs, legal and personal representatives, successors and assigns of said parties. No rights, however, shall inure to the benefit of any assignee of CCI unless the assignment to such assignee has been approved by PCIC.

This writing contains the entire agreement between the parties hereto, and no agent, representative or officer of either party has authority to make or has made any statement, agreement or representation, either oral or written, in connection herewith, modifying, adding or changing the terms and conditions herein set forth. No dealings between the parties or custom shall be permitted to contradict various additions to or

BSSF2333

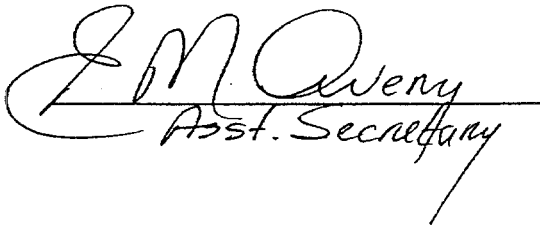
BS 00300

1

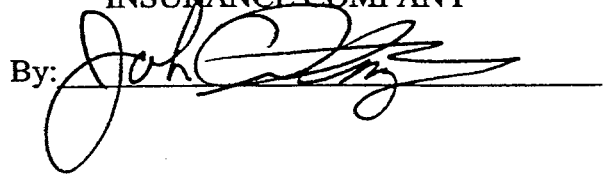
modify the terms hereto. No modification of this Agreement shall be binding unless such modifications shall be in writing and signed by the parties hereto.

IN WITNESS WHEREOF, the parties, intending to be legally bound hereby, have caused this Agreement to be duly signed upon the day, month and year first above written.

ATTEST:


Asst. Secretary

PCIC:
PENNSYLVANIA CONTRACTORS
INSURANCE COMPANY

By: 

BSSF2334